DOCUMENT RESUME

ED 381 059 HE 028 182

TITLE	High Risks and Emerging Fraud: IRS, Student Loans, and HUD. Hearing before the Committee on Governmental Affairs. United States Senate, One Hundred Third Congress, Second Session (July 19, 1994).
INSTITUTION	Congress of the U.S., Washington, D.C. Senate.
REPORT NO	ISBN-0-16-046792-6; Senate-Hrg-103-975
PUB DATE	95
NOTE	120p.
AVAILABLE FROM	Superintendent of Documents, Congressional Sales Office, U.S. Government Printing Office, Washington, DC 20402.
PUB TYPE	Legal/Legislative/Regulatory Materials (090)
EDRS PRICE	MF01/PC05 Plus Postage.
DESCRIPTORS	*Federal Programs; Hearings; Higher Education; Program Improvement; *Public Housing; *Risk; Risk Management; *Student Loan Programs; *Taxes
IDENTIFIERS	Congress 103rd; Department of Education; Department of Housing and Urban Development; Family Education Loan Program; *Fraud; General Accounting Office; Internal Revenue Service

ABSTRACT

These hearing transcripts present testimony on the high risks and emerging fraud in several areas of the federal government, including the Student Loan Program of the Education Department (ED), the Multifamily Housing Program of the Department of Housing and Urban Development (HUD), and Internal Revenue Service (IRS) tax return filing. Testimony was heard from concerned senators and government officials responsible for risk management and fraud in these departments and agencies. Current and possible solutions to risk management and fraud were discussed. Opening and/or prepared statements were given by: Senators John Glenn, Byron L. Dorgan, Jim Sasser, William S. Cohen, and William V..Roth, Jr. Testimony was heard from: (1) the special assistant to the comptroller general and the director of tax systems issues, General Accounting Office (GAO); (2) the commissioner, deputy commissioner, and other officials of the IRS; (3) the deputy secretary, inspector general, and other officials of ED; and (4) the inspector general, assistant inspector general for audit, and other officials of HUD. An appendix contains the prepared statements of several witnesses, along with written questions and answers from officials of GAO, ED, HUD, and the Department of Treasury. (MDM)

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HIGH RISKS AND EMERGING FRAUD: IRS, STUDENT LOANS, AND HUD

HEARING

BEFORE THE

COMMITTEE ON GOVERNMENTAL AFFAIRS UNITED STATES SENATE

ONE HUNDRED THIRD CONGRESS

SECOND SESSION

JULY 19, 1994

Printed for the use of the Committee on Governmental Affairs

HE 028 182

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81-669 cc WASHINGTON : 1995

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CONTENTS

	Page
Opening statements:	
Senator Glenn	1
Senator Dorgan	9
Senator Sasser	10
Prepared statement:	
Senator Cohen	7
Senator Roth	69

WITNESSES

TUESDAY, JULY 19, 1994

James Hinchman, Special Assistant to the Comptroller General, U.S. General Accounting Office, accompanied by Hazel Edwards, Director, Tax Systems Issues	12
Margaret Milner Richardson, Commissioner, Internal Revenue Service, accompanied by Mike Dolan, Deputy Commissioner, Ted Brown, Refund Fraud Executive, Hank Philcox, Chief Information Officer, and Larry Westfall, Modernization Executive	15
James B. Thomas, Jr., Inspector General, U.S. Department of Education	39
Madeleine Kunin, Deputy Secretary, U.S. Department of Education, accompanied by Leo Kornfeld, Deputy Assistant Secretary for Student Financial Assistance, and Don Wirtz, Chief Financial Officer	42
Susan Gaffney, Inspector General, U.S. Department of Housing and Urban Development, accompanied by Chris Greer, Assistant Inspector General for Audit	54
Nicolas P. Retsinas, Assistant Secretary for Housing and Federal Housing Commissioner, U.S. Department of Housing and Urban Development, accompanied by Conrad Eagan, Special Assistant to the Commissioner	59

ALPHABETICAL LIST OF WITNESSES

Gaffney, Susan:	
Testimony	54
Prepared statement	94
Hinchman, James:	
Testimony	12
Prepared statement	69
Kunin, Madeleine:	
Testimony	42
Prepared statement	90
Retsinas, Nicolas P.:	
Testimony	59
Prepared statement	99
Richardson, Margaret Milner:	
Testimony	15
Prepared statement	74
Thomas, James B. Jr.:	
Testimony	39
Prepared statement	83

APPENDIX

Page

Prepared statements of witnesses in order of appearance 69
Questions and answers from:
Hazel E. Edwards, Director, Information Resouces Management/General Government Issues, GAO 105
Margaret Richardson, Department of the Treasury 107
James Thomas, Jr., U.S. Department of Education 110
Susan Gaffney, Inspector General, U.S. Department of Housing and Urban Development 112

HIGH RISKS AND EMERGING FRAUD: IRS, STUDENT LOANS, AND HUD

TUESDAY, JULY 19, 1994

U.S. SENATE,
COMMITTEE ON GOVERNMENTAL AFFAIRS,
Washington, DC.

The Committee met, pursuant to notice, at 9:34 a.m., in room SD–342, Dirksen Senate Office Building, Hon. John Glenn, Chairman of the Committee, presiding.

Present: Senators Glenn, Sasser, Dorgan, and Cohen.

OPENING STATEMENT OF CHAIRMAN GLENN

Chairman GLENN. Good morning. The hearing will be in order.

Today the Committee on Governmental Affairs meets to discuss the high risks and emerging fraud in several areas in the Federal Government. This Committee, which has as part of its mandate the job of pointing out the waste, fat, fraud and abuse in Government programs, was involved in establishing the high-risk programs of the Office of Management and Budget and the General Accounting Office back in 1989. I would add that we asked for independent assessments of the highest-risk areas of Government, with the biggest dangers and the potential for a lot of loss was in Government, and they came up with separate assessments. In most areas, they were pretty much in agreement with each other.

We have been involved ever since in monitoring the Government's high-risk list—those reports are put out each year—and in ensuring that those agencies take necessary corrective action to improve performance and reduce cost to the Government and the American taxpayer.

I think the high-risk programs have been very effective, focusing management attention on the Government's greatest vulnerabilities. It is embarrassing for agencies to have these programs put on their lists, and as a result, we have seen a lot of agencies work hard at fixing problems so they get off the list or, if the problems are really bad, at least make some headway.

To me, that means the process is working—not well enough, not the way we would like to see it work, but it is working. Now we know even more than we did in the past about what is going on. We have annual CFO reports and IG reports and investigations that ferret out fraud, wrongdoing and abuse. Those were measures passed by this Committee, and they are working. We are beginning to have all the tools in place that will help us better manage the Government.

This morning's hearing focuses on three agencies with high-risk problems. In two of these cases—the Education Department's Student Loan Program and HUD's Multifamily Housing Program—complex problems put them on the high-risk list from the very beginning, and they have been there ever since. That is disappointing.

The third case, IRS tax return filing fraud, does not appear on the high-risk lists. In my opinion, the growth of detected fraud in this program requires that it be listed.

For this reason, I am in the process of writing to acting OMB Director Alice Rivlin and to Comptroller General Charles Bowsher, requesting that the IRS tax return filing program be added to their high-risk lists.

Like the Government's other worst vulnerabilities, the issue of tax return filing fraud should remain on the high-risk list until we get it under full control.

Regarding IRS filing fraud, let me State at the outset that I think Commissioner Richardson, who is with us here this morning, is doing a great job with a very, very tough problem. In my opinion, she has taken on this problem after too many years of lip-service by IRS and by previous commissioners. As long as there have been taxes, there have been people trying to scam the system, and I doubt that we will ever eliminate tax fraud 100 percent altogether.

We are a self-taxing people; we depend on our citizens to make their reports honestly and straightforwardly. This means that the system, though, must be sound for it to remain credible.

Nonetheless I am very concerned about the rapid growth of detected fraud in the filing system in the past several years. Recently, a lot of attention has been paid to increased fraud in the electronic filing program, but I am just as worried about fraud in the traditional paper filing program. Last year, detected paper filing fraud quadrupled, while it doubled in the electronic area. As Ms. Richardson will testify, the IRS estimates that the total number of detected fraudulent returns is likely to double again this year. Of course, what no one knows is just how quickly actual fraud is growing—in other words, how much of this is actual fraud increase, and how much of it is better detection. I think we still have a big question mark in that area, and it is one that we have to look at very carefully.

As hard as they are trying, I am not convinced that the IRS has the capacity or the technology to keep up with the ingenuity and the volume of fraudulent tax filing schemes. We cannot be sure that the IRS is actually detecting a higher percentage of fraud, although I think they know better today what to expect in terms of fraud.

The agency is taking a very serious look at fraud in its filing programs. This Committee wants to work with Commissioner Richardson to give Congress a clear and doable plan before the next filing season that establishes better safeguards and performance measures for curbing this alarming problem which, along with the $150 billion tax gap, threatens to undermine the foundations of our voluntary tax system.

I am requesting this morning that she provide us with just such a plan. We have discussed this in the past, and I think she has

been working on that plan, and we would like to have that so we know what to expect before the next filing season.

If we are unable to stop fraud from doubling and tripling every year, or determine whether this is better reporting or better catching of people who are in error, then I think we have to consider suspending the electronic filing program, which is where the Government tends to lose more in bogus refunds, until we can better perfect the system.

Now, I do not believe that it is necessary to suspend that program now, but I do think it is a very serious matter which needs immediate attention.

Moreover, IRS must do a better job of safeguarding the privacy of America's financial and tax information. Last August, this Committee revealed that hundreds of IRS employees had been investigated for browsing through the tax records of neighbors, friends, relatives, celebrities. At the time, Commissioner Richardson testified that even one violation of America's privacy was too many, and we agree with her completely. Yet we recently learned that IRS since 1989 has investigated more than 1,300 employees for unauthorized access to taxpayer records, at least 420 of whom have been penalized for their activity.

What disturbs me is that more than 500 of these investigations have occurred since our hearing last August and since the Commissioner issued strong guidance that browsing or other unauthorized access would not be tolerated at the IRS. I applaud the Commissioner for her swift action, and I commend the Office of Investigations for all the hard work that has been done in this area. IRS employees must understand that browsing is not acceptable for whatever reason, whether it is prurient window-peeping attitudes, or with fraud in mind, which some cases turned up; either one is unacceptable. If the Congress needs to pass stronger legislation to ensure America's right to tax privacy or to make violating that privacy a criminal offense, then we will do that.

We will also do our best to ensure that the Tax Systems Modernization Program, or TSM, if supported by a strong business plan, is appropriately funded. TSM will help to better detect fraud and stop browsing, and furthermore, it is absolutely essential to the 21st century vision of an IRS that works better and costs less.

In the meantime, I cannot emphasize enough there is zero tolerance for IRS employees who violate Americans' right to privacy.

I mentioned adequate funding a moment ago, and that is absolutely essential. With over $21 billion out there in collectibles—not just owned, but what is estimated as being collectible if we just had the people to go out there after it; I think it is $130-some billion that is actually estimated that is owed to the Government, but a lot of that is in individual bankruptcies or business bankruptcies and is not collectible—but this $21 billion is out there and is estimated to be collectible if we could just go out and get it. So it is false economy in the extreme, I think, to cut IRS funding and their ability to go out and get that kind of money.

The current proposed $400 million cuts to Tax System Modernization which the Committees are working on and supposed go to conference on perhaps this week, I think those cuts are a very serious mistake.

I have talked repeatedly to former OMB Chief Panetta, who is now White House Chief of Staff, and Alice Rivlin, who will soon take over at OMB, about this matter, and of course, we all want a lean, efficient operation in all of Government; but chopping away at the IRS budget and personnel might be penny-wise at the moment, but I think would be pound-stupid for the long term.

I believe Commissioner Richardson is on the right track, but we must not hold back on the tools she needs to do the job. Then I will feel fully justified in putting her stewardship under a real microscope here.

Turning to our other high-risk issues this morning, the Committee remains very concerned with the fragile State of the Government's student loan program. Senator Nunn, who chairs our Permanent Subcommittee on Investigations, has led the way in exposing the fraud and mismanagement crippling the student loan program, which has caused billions of dollars in losses to the Government and the taxpayer. Now, as we are creating from scratch a new direct student loan program to overcome past problems, there are indications that the Education Department may transfer to it some of the old program's fatal flaws.

Education's Inspector General warns that the Department is embarking on a high-wire act. They are quickly starting up the new program while still administering the old one. In the new direct student loan program next year, for instance, Education must increase the number of schools getting loans from around 100 to about 3,000. That worries me. I think if we are not careful, Education could have two student loan programs on the high-risk list instead of one. And thus, just as I have asked Commissioner Richardson for a plan, I also request from Deputy Secretary Kunin, who will testify later, that the Education Department provide the Congress with a plan by the end of the year that establishes the safeguards, milestones, and performance measures by which we can judge whether the new direct student loan program is successful at avoiding the old program's problems, or whether we need to pull the plug. This high-wire act could otherwise end up in a very expensive accident.

The third high-risk issue we will look into today is HUD, which is no stranger to fraud and abuse. Recently, as part of Operation Safe Home, the Inspector General began pursuing more than 100 cases of multifamily housing equity skimming in which owners and managers diverted Federal money for private use. I am pleased that HUD has recognized this terrible practice and has taken steps to detect and prosecute perpetrators of this type of fraud. But I worry that the magnitude of equity skimming, in which some individual cases reach millions of dollars, could overwhelm HUD's already scarce resources.

At this time, it is my understanding HUD does not collect statistics on equity skimming from its field offices; it does not even collate these examples from all the field offices so we can have a grasp of the enormity of the problem. So it is very difficult for the Department to recognize the magnitude of the problem it faces or to analyze patterns that could aid future detection of equity skimming.

Why not? I would urge our HUD witness, the Assistant Secretary for Housing, to have this information collected and collated and analyzed on a regular basis so the Government can limit its exposure to fraud.

Getting off the high-risk list will take aggressive action from HUD.

Finally, let me welcome our witnesses here this morning. Our first panel includes James Hinchman, Special Assistant to the Comptroller General of the General Accounting Office, and Margaret Milner Richardson, Commissioner of Internal Revenue.

On our second panel are James Thomas, Inspector General of the Education Department, and Madeleine Kunin, the Deputy Secretary of Education.

The Inspector General of HUD, Susan Gaffney, and the Assistant Secretary of Housing, Nicolas Retsinas, comprise our third panel.

Thank you.

PREPARED STATEMENT OF SENATOR GLENN

Good morning. Today the Committee on Governmental Affairs meets to discuss high risks and emerging fraud in the Federal Government.

This committee, which has as part of its mandate the job of pointing out the waste, fat, fraud and abuse in government programs, was involved in establishing the high risk programs of the Office of Management and Budget and the General Accounting Office back in 1989. And we have been involved ever since in monitoring the government's high risks, and in ensuring that agencies take necessary corrective actions to improve performance and reduce costs to the government and the American taxpayer.

I think that the high risk programs have been very effective in focusing management attention on the government's greatest vulnerabilities. It is embarrassing for agencies to have their programs put on these lists: as a result, we've seen a lot of agencies work hard at fixing problems so that they can get off the list or, if the problems are really bad, at least make some headway. That means the process is working. And now, we know even more than we did in the past about what's going on—we have annual CFO reports and IG reports and investigations that ferret out fraud, wrong-doing and abuse. We are beginning to have all the tools in place that will help us better manage the government.

This morning's hearing focuses on three agencies with high risk problems. In two of these cases—the Education Department's Student Loan program and HUD's Multifamily Housing program—complex problems put them on the high risk list from the very beginning, and they have been there ever since. The third case, IRS tax return filing fraud, does not appear on the high risk lists, but in my opinion, the alarming growth of detected fraud in this program requires that it be listed.

For this reason, I have written to acting OMB Director Alice Rivlin and to Comptroller General Charles Bowsher, requesting that the IRS tax return filing program be added to their high risk lists. Like the government's other worst vulnerabilities, the issue of tax return filing fraud should remain on the high risk list until we get it under control.

Regarding IRS filing fraud, let me state at the outset that I think Commissioner Richardson is doing a terrific job with a tough problem. In my opinion, she has taken on this problem after too many years of lip service by IRS. As long as there have been taxes, there have been people trying to scam the system, and I doubt that we will ever eliminate tax fraud altogether. We are a self-taxing people, and this means that the system must be sound for it to remain credible. Nonetheless, I am very concerned about the rapid growth of detected fraud in the filing system in the past several years. Recently, there has been a lot of attention paid to increased fraud in the electronic filing program, but I am just as worried about fraud in the traditional paper filing program—last year, detected paper filing fraud quadrupled while it doubled in the electronic area. As Mrs. Richardson will testify, the IRS estimates that the total number of detected fraudulent returns is likely to double again this year—of course, what no one knows is just how quickly actual fraud is growing.

As hard as they are trying, I am not convinced that the IRS has the capacity or the technology to keep up with the ingenuity and volume of fraudulent tax filing schemes. We cannot be sure that the IRS is actually detecting a higher percentage

of fraud, although I think they know better today what to expect in terms of fraud. The agency is taking a serious look at fraud in its filing programs. We want to work with Commissioner Richardson to give Congress a clear and do-able plan, before the next filing season, that establishes better safeguards and performance measures for curbing this alarming problem which, along with the $150 billion tax gap, threatens to undermine the foundations of our voluntary tax system. And I am requesting this morning that she provide us with just such a plan. If we are unable to stop fraud from doubling and tripling every year, then I think we will have to consider suspending the electronic filing program—which is where the government tends to lose more in bogus refunds—until we can better protect the system. I don't believe that it is necessary to suspend the program now, but I do think that it is a very serious matter which needs immediate attention.

Moreover, IRS must do a better job of safeguarding the privacy of Americans' financial and tax information. Last August, this Committee revealed that hundreds of IRS employees had been investigated for browsing through the tax records of neighbors, friends, relatives and celebrities. At the time, Commissioner Richardson testified that even one violation of Americans' privacy was too many. Yet we recently learned that IRS since 1989 has investigated more than 1,300 employees for unauthorized access to taxpayer records—at least 420 of whom have been penalized for their activity.

What disturbs me is that more than 500 of these investigations have occurred since our hearing last August and since the Commissioner issued strong guidance that browsing or other unauthorized access would not be tolerated at the IRS. I applaud the Commissioner for her swift action and I commend the Office of Investigations for all the hard work that's been done in this area. IRS employees must understand that browsing is not acceptable for whatever reason—prurient "window peeping" or with fraud in mind. If the Congress needs to pass stronger legislation to ensure Americans' right to tax privacy—or to make violating that privacy a criminal offense—then we will do that.

We will also do our best to ensure that the Tax Systems Modernization program, if supported by a strong business plan, is appropriately funded—TSM will help to better detect fraud and stop browsing, and, furthermore, it is absolutely essential to the 21st century vision of an IRS that works better and costs less. In the meantime, I cannot emphasize enough: there is zero tolerance for IRS employees who violate Americans' right to privacy.

I mentioned adequate funding. That is absolutely essential. With over $21 billion out there in collectibles, it is false economy in the extreme to cut IRS funding. The current proposed $400 million cuts to Tax Systems Modernization are a serious mistake, I believe. I have talked repeatedly to former OMB Chief Panetta—now White House Chief of Staff—and Alice Rivlin, who will soon take over at OMB, about this matter. Of course, we want a lean, efficient operation in all of government, but chopping away at the IRS budget and personnel might be penny-wise at the moment, but would be pound-stupid for the long term. I believe Commissioner Richardson is on the right track, but we must not hold back on the tools she needs to do the job. Then I will feel fully justified in putting her stewardship under a microscope.

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Education's Inspector General warns that the department is embarking on a high-wire act: they are quickly starting up the new program, while still administering the old one. In the new Direct Student Loan program next year, for instance, Education must increase the number of schools getting loans from around 100 to about 3,000. That worries me. I think that if we are not careful, Education could have two student loan programs on the high risk list instead of one. Thus, just as I have asked Commissioner Richardson for a plan, I also request from Deputy Secretary Kunin that the Education Department provide the Congress with a plan by the end of the year that establishes the safeguards, milestones and performance measures by which we can judge whether the new Direct Student Loan Program is successful at avoiding the old program's problems—or whether we need to pull the plug. This high-wire act could otherwise end in very expensive accident.

The third high risk issue we will look into today is HUD—which is no stranger to fraud and abuse. Recently, as part of operation Safe Home, the Inspector General began pursuing more than 100 cases of Multi-family Housing equity skimming, in

which owners and managers diverted Federal money for private use. I am pleased that HUD has recognized this terrible practice and has taken steps to detect and prosecute perpetrators of this type of fraud, but I worry that the magnitude of equity skimming—in which some individual cases reach millions of dollars—could overwhelm HUD's already scarce resources.

At this time, it is my understanding that HUD does not collect statistics on equity skimming from its field offices, so it is very difficult for the department to recognize the magnitude of the problem it faces, or to analyze patterns that could aid future detection of equity skimming. Why not? I would urge our HUD witness, the Assistant Secretary for Housing, to have this information collected, collated and analyzed on a regular basis so that the government can limit its exposure to fraud. Getting off the high risk list will take aggressive action from HUD.

Finally, let me welcome our witnesses here this morning. On our first panel are James Hinchman, special assistant to the Comptroller General of the General Accounting Office, and Margaret Milner Richardson, Commissioner of Internal Revenue. On our second panel are James Thomas, Inspector General of the Education Department, and Madeleine Kunin, the Deputy Secretary of Education. The Inspector General of HUD, Susan Gaffney, and the Assistant Secretary of Housing, Nicholas Retsinas, comprise our third panel.

Thank you.

Chairman GLENN. Senator Cohen, do you have any comments?

Senator COHEN. Thank you, Mr. Chairman. I do have a statement I would like to submit for the record, and I commend you for holding the hearing.

Chairman GLENN. Without objection, it will be included.

PREPARED STATEMENT OF SENATOR COHEN

Mr. Chairman, I would like to commend you for holding this hearing to examine fraud and abuse in several of the government's so-called "high risk" programs.

Specifically, today's hearing will focus on instances of fraud and abuse at the Internal Revenue Service (IRS), the Department of Education's Student Loan Program and the Department of Housing and Urban Development (HUD). While I intend to focus much of my attention on improving oversight at HUD, I would like to briefly mention my concerns with problems at the IRS and the Department of Education's management of the federal student loan program.

As government attempts to be a part of the so-called "information superhighway," it raises new opportunities to defraud the federal government. Nowhere in the government is this more evident than with the IRS who in the first 10 months of last year alone, identified some $53 million in fraudulent electronic refunds. Many believe that this figure represents only the tip of the iceberg and in February, the Commissioner of IRS suggested in testimony before a House Ways and Means Subcommittee, that cases of electronic fraud may actually be costing the taxpayers billions.

In a specific case involving fraudulent filing, an Atlanta tax preparer who was familiar with the IRS electronic filing system, bilked the taxpayers out of more than $500,000 over a 2 year period. The scam worked like this: he obtained phony employer ID numbers from IRS by applying over the phone. The application process took less than five minutes. He then used the bogus ID numbers to create fraudulent wage statements and then claimed more than half a million dollars in refunds by electronically filing false tax returns using the social security number of unemployed persons.

The Department of Education's problems in maintaining adequate oversight of student loan guarantees and Pell Grant funds is also well documented. The Governmental Affairs Permanent Subcommittee on Investigations (PSI) has exposed significant problems and Congress has responded through legislation now being implemented.

Recent testimony by the Department of Education's Inspector General before the House Appropriations Subcommittee on Labor, HHS and Education has raised another twist in the area of Student Loan fraud—the failure of schools to appropriately refund millions of dollars of unearned student loan proceeds to the lenders. Many students that have withdrawn from schools are now being harassed by bill collectors for payment of loans, having their wages garnished, losing their tax refunds, and because of their defaulted loans, are ineligible for future federal education aid. In some cases, schools closed leaving students solely responsible for the repayment of loans. This type of fraud has two clear losers—the federal government

who generally never recovers those funds and the former students who are getting stuck with bills for an education they never received.

Finally, the Committee will examine how the Department of Housing and Urban Development (HUD) has been exposed to billions of dollars in fraud due to something known as "equity skimming." Equity skimming occurs when operators of multifamily housing units do not meet their debt or maintenance obligations and yet divert funds to improper or personal use.

According to the HUD IG, equity skimming is costing the taxpayers billions. The IG has identified some $22 million in equity skimming losses while auditing less than 1 percent of HUD's defaulted loans. If we do some simple math, the government may, at the very least, attribute $2.2 billion out of its current $10 billion portfolio of defaulted mortgages to equity skimming.

There are many well-documented cases of equity skimming. For example, one building owner in Texas used federal rent subsidies to pay members of the Texas A&M football team instead of paying on his HUD insured mortgage.

Two other recent cases of equity skimming in Minnesota cost the government almost $600,000. In one case, two partners collected rent and government subsidies while failing to make full mortgage payments on their federally insured mortgages. The total cost to the taxpayers in this case was about $425,000. In the other case, two owners of five subsidized buildings collected more than $173,000 in rent while neglecting to make mortgage payments.

In upstate New York, partners in a nursing home claimed to be broke and failed to make payments on a $5.1 million HUD-insured mortgage. At the same time they were defaulting on the mortgage and sticking the taxpayers with the bill, the partners used various guises to divert some $500,000 to personal use and paid themselves another $1.7 million in fees for unverified services. While these partners were lining their own pockets, there was strong evidence that the nursing home residents were receiving substandard care.

While there are a number of cases which have been successfully prosecuted, there are many which go unprosecuted because the cases are too cumbersome to pursue under existing law. In recent months, I have been working with the HUD IG to develop increased civil enforcement authority so that it may aggressively and successfully pursue these cases. Additionally, I want to assist the HUD IG to retain funds it is able to collect from equity skimming cases so they may be used to cover the cost of its investigation. My staff will continue to work with the HUD IG and I hope to introduce legislation in the coming weeks that will help curb equity skimming.

Mr. Chairman, thank you for holding this hearing this morning and I look forward to hearing testimony from the witnesses.

Senator COHEN. And I commend you for focusing on these three key areas, with respect to IRS, about a year ago—actually, I believe it was in 1991—GAO testified that the IRS had a 1950's era tax processing system, and of course, when you say "1950's era," that conjure sup images of a mainframe the size of this room, with vacuum tubes and transistors and keypunch operators. I am not sure whether that image is exaggerated or not, but it is clear that the IRS has been trying to come into the 21st century as far as modernizing its systems. But I must say, as Senator Glenn has pointed out, that this Tax System Modernization program is in trouble.

It is in trouble, according to GAO, because there has not been a definite plan that has been associated with it, or a defined enough plan to warrant continuation of the program unless we have greater specificity in terms of exactly what it hopes to accomplish.

The figure that has been associated with that particular modernization program is about $8 billion, as I recall, and that $8 billion may not be enough in the event we do not have greater definition for the program.

But I must say that as the IRS tries to come into the 21st century and get aboard the information superhighway, it may prove to be a highway to hell, unless we take the kinds of precautions that are necessary so we do not have the kind of fraud that is appar-

ently increasing in terms of the electronic filing system that has been adopted by the IRS.

Just a couple of comments, Mr. Chairman, about equity skimming at HUD. I am pleased that we are focusing on that. According to HUD's IG, equity skimming is costing the taxpayers billions of dollars. They have identified some $22 million in equity skimming losses while actually only auditing less than one percent of HUD's defaulted loans. And if you do some simple math on this, the Government may, at the very least, attribute some $2.2 billion out of its current $10 billion portfolio of defaulted mortgages to equity skimming.

And there are quite a few well-documented cases of equity skimming. One example is a building owner in Texas who used Federal rent subsidies to pay members of the Texas A and M football team instead of paying his HUD-insured mortgage.

There were two other recent cases of equity skimming in Minnesota that cost the Government almost $600,000. In one case, there were two partners who collected rent and Government subsidies while failing to make their full mortgage payments on their federally-insured mortgages. The total cost to the taxpayers in that case was about $425,000.

In another case, two owners of five subsidies buildings collected more than $173,000 in rent payments while neglecting to make any payments on the mortgage.

In Upstate New York, partners in a nursing home claimed to be broke; they failed to make payments on a $5.1 million HUD-insured mortgage. At the same time they were defaulting on this mortgage and sticking the taxpayers with the bill, the partners used various guises to divert some $500,000 to personal use, and they paid themselves another $1.7 million in fees for unverified services. While these partners were lining their own pockets, there was pretty strong evidence that the nursing home residents were receiving substandard care.

So these and other cases, Mr. Chairman, often go unprosecuted because the cases are simply too cumbersome to pursue under existing law. In recent months, I have been working with the HUD IG to develop increased civil enforcement authority so they can aggressively and successfully pursue these cases; and hopefully, we can also assist the HUD IG to retain funds that it is able to collect from these equity skimming cases so they can be used to cover the cost of the investigation. But we will continue to work with the HUD IG to develop this legislation so we can pursue it in the very short future.

I thank you for the hearing, and I would offer my full statement for the record.

Chairman GLENN. Thank you.

Senator Dorgan.

OPENING STATEMENT OF SENATOR DORGAN

Senator DORGAN. Mr. Chairman, thank you very much.

I, too, appreciate the hearing. I got the hearing record from last August; I wanted to review what was disclosed last August about unauthorized disclosure and browsing of income tax returns, and compare that with what is being discussed today.

I do want to say that I know that electronic filing is appealing to the IRS because it can promote breathtaking efficiency. But I think it also poses a very serious challenge to prevent fraud and unauthorized disclosure. And I was chagrined and concerned this morning to see the stories in the newspaper resulting from additional information which has been offered about browsing and snooping in the IRS files.

There is nothing, in my judgment, that undermines as quickly or as certainly the authority of a taxing agency as a story about snooping or browsing. I used to run a taxing agency, and penalties for those in my agency for unauthorized disclosure were criminal penalties; and when I hired people, I made certain they understood that if there was any question about snooping, any question about browsing, any question about unauthorized disclosure, they were no longer going to be working.

One of the questions I want to ask today is what has been the penalty. Do people in the Internal Revenue Service at this point and from this point forward know that there is zero tolerance here—that they cannot, will not browse through returns, snoop, and certainly will not in any way disclose in an unauthorized manner information which is among the most sensitive personal information that people have, that they file with the Federal Government and with the Internal Revenue Service, expecting that it will remain, as the law contemplates, confidential.

So I will ask some questions about that. I have been a person who believes we must have an effective Internal Revenue Service System; we should make sure everyone pays his fair share. The IRS should be fair in the way it administers that system, and again, in these circumstances, I would expect and I think all of us would expect that the IRS would take certain and immediate action to make sure this does not happen again.

Mr. Chairman, thank you very much. I will be interested in asking a series of questions.

Chairman GLENN. Thank you.

Senator Sasser.

OPENING STATEMENT OF SENATOR SASSER

Senator SASSER. Thank you very much, Mr. Chairman.

First, I want to join in commending you for holding these hearings here today. I think it ought to be apparent to everybody that it takes a great deal of effort, ongoing, continuous vigilance, to keep waste and fraud out of our Government programs. The business of rooting out fraud and rooting out waste is more than just a sound bite on the evening news. It is something that must go on every day, through constant vigilance and through the kind of oversight hearings, Mr. Chairman, that you have been guiding our Committee through, and I think your persistance is commendable, and I am pleased to be here today to assist you.

I want to join in the statement that Senator Dorgan made about my shock and chagrin about the unauthorized browsing through IRS returns that is apparently going on in some of our IRS Service Centers. I was shocked to learn that employees numbering in the hundreds have been asked about this problem in the IRS Southeast Center in Memphis, Tennessee.

I am encouraged to see that the IRS is taking stronger measures to control unauthorized browsing. I have long had a concern about the compilation of personal information by Government agencies—and private agencies, for that matter. I think that does represent a potential serious invasion of privacy and the potential for the misuse of this personal and intimate financial and economic information that is very large.

So I am particularly disturbed to see that there has been unauthorized and illegal window-peeping. I think that is about all you could call it, this sort of peeping Tom mentality where people want to look into someone else's IRS return just for the purpose of satisfying their own morbid curiosity, and I think that is something that we simply cannot tolerate. The IRS and every Government agency have the obligation to make sure that the citizens' forms that are filed containing confidential information are sacrosanct and guarded vigilantly against unauthorized use.

Mr. Chairman, the Department of Education has suffered a prolonged bloody nose from the persistent fraud in the student loan program. Much of it has been uncovered by the Permanent Subcommittee on Investigations, on which I serve, and efforts to reform the Guaranteed Student Loan Program have given birth to a new Direct Student Loan Program. But no one should be shocked to learn that some of the same problems exist with the new program as existed with the old one. The total loan loss for student loans runs in the range of 20 percent—that is almost $30 billion—since the inception of the program. Clearly, the student loan program is going to need our continue and close monitoring.

And finally, after staggering out of the 1980's, in which mismanagement and cronyism seemed to be the order of the day in HUD, we are now having problems once again. I think the Department of Housing and Urban Development has taken some very significant steps here in the last year or two in an effort to get its house back in order, but I am concerned about these allegations of nearly $12 million of HUD money that may be at risk due to this fraudulent practice of equity skimming. That is certainly an inappropriate use of multifamily housing loans, if not a criminally inappropriate use.

So clearly, Mr. Chairman, we have still got a long way to go, but as the Chinese say, a march of 1,000 miles begins with the first step, and I want to commend you for continuing to exercise vigilant oversight in your role as Chairman of this Governmental Affairs Committee.

Chairman GLENN. Thank you very much.

Our first witness this morning is James Hinchman, Special Assistant to the Comptroller General, U.S. General Accounting Office, followed by the honorable Margaret Milner Richardson, Commissioner of the Internal Revenue Service.

Mr. Hinchman, if you would lead off, we would appreciate it, and if you would introduce the people accompanying you this morning, please.

TESTIMONY OF JAMES F. HINCHMAN,[1] SPECIAL ASSISTANT TO THE COMPTROLLER GENERAL, U.S. GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY HAZEL EDWARDS, DIRECTOR, TAX SYSTEMS ISSUES

Mr. HINCHMAN. Yes, sir. I am accompanied this morning by Hazel Edwards, of our Accounting and Information Management Division. She has played a major role in our work reviewing the information systems at the Internal Revenue Service.

Both of us are pleased to be here to share our ideas on three important and sensitive issues that are the focus of the Committee's attention in the first part of today's hearing: controlling fraud in the IRS filing system; safeguarding taxpayer automated files from unauthorized access and manipulation by IRS employees; and more generally, removing unnecessary risk from the IRS' computer systems environment.

I have a somewhat lengthy statement, and with the Committee's permission, I will insert that in the record and summarize.

Chairman GLENN. Without objection, the entire statement will be included, and I will say to all the witnesses that if you have a longer statement, they will all be included without objection.

Mr. HINCHMAN. Thank you, Mr. Chairman.

I also want to say on a personal note that I am personally honored by the chance to appear on this panel with Commissioner Richardson.

If I had to summarize our statement in a couple of sentences, I would say that the IRS has recognized the severity of its problems in these three areas I just mentioned; that it has taken steps and plans to take others to resolve them, but that we need to recognize that the task is great, and progress has been slow.

Additional action and sustained leadership are going to be necessary if the problems are going to be surmounted.

Let me turn first to the question of controlling fraud in electronic filing. I think we need to recognize that in recent years, Americans have come to expect quick access to information and services in their dealings with private sector enterprises, and not surprisingly, they are increasingly coming to expect the same kind of quick service from their Government.

Today's automated technology has greatly increased IRS' ability to deliver services and access information rapidly. However, along with this technology have come new and greater challenges to protect this highly sensitive taxpayer data which IRS possesses.

Electronic filing to date has shown the potential for a paperless tax filing system. Since 1990, the number of individual tax returns filed electronically has increased dramatically—from 4.2 million in 1990, when the system was first offered Nationwide, to 13.5 million this year. Looking ahead, IRS believes, I think properly, that electronic filing is the cornerstone of its future. Its goal is to receive 80 million returns electronically by the beginning of the next century.

However, this electronic filing has come at a price. The rate of fraudulent return losses in electronic filing are high. Thus far, the number of electronic returns identified as fraudulent in any 1 year

[1] The prepared statement of Mr. Hinchman appears on page 69.

has been relatively low in absolute numbers. For example, in 1993, the number is something like 26,000 cases have identified fraudulent refunds. These returns involve something like $50 million.

However, the growth rate in this fraud is very high. As of July of this year, IRS had received about 110 million individual tax returns, of which about 13.5 million were filed electronically, some nearly 10 percent more than the previous year.

By comparison, IRS' reports show that 64 percent more fraudulent electronically filed returns have been identified during the first 5 months of this year than in the same period of last year, nearly 21,000 compared to just under 13,000 last year.

More importantly, the rate of detected fraudulent refund losses is much higher for electronically filed returns than for paper returns.

We have made several recommendations to improve IRS' controls over electronically filed fraud. These recommendations involve improved screening and monitoring of persons and firms who are authorized to do return filing electronically; better validation and editing within the electronic filing systems to help prevent fraudulent electronic returns from being accepted by the system; and better detection of fraudulent returns that have been accepted. IRS is working on all of these areas, but, as I think they acknowledge, problems remain.

The second issue before the Committee today is unauthorized browsing of taxpayer accounts, an issue that was addressed at length in this Committee's hearings last August. At that time, we testified that IRS did not adequately control access authority given to computer support personnel to adequately monitor employee access to taxpayer accounts.

For example, a 1992 IRS internal audit found that some employees have used their access to monitor their own fraudulent returns, to issue fraudulent refunds, and to inappropriately browse through taxpayer accounts.

Since that hearing, an examination of all of its regional offices has led to a finding that IRS has similar problems throughout the country. IRS has also evaluated the disposition of the Southeast Region's suspected browsing cases that were discussed last year. Overall, IRS' Office of Ethics concluded, and I think IRS management agrees, that disciplinary action in 51 of the 328 cases reviewed were too lenient. Moreover, the Office of Ethics found cases of inconsistent punishment for similar offenses, including disparate treatment between offices and within the same office.

IRS has revised its penalty guidelines since then to set minimum and maximum penalties for violating computer security and privacy laws. The guidance does provide important assistance to managers to encourage fair and consistent application of penalties, and the task ahead now is to assure their effective implementation.

An internal systems security study commissioned by IRS in 1993 pointed out that one of the greatest security risks that IRS faces is its own employees. The same year, a review by IRS' internal auditors found that there were virtually no controls programmed into the Integrated Data Retrieval Systems—one of IRS' most important databases—to limit what employees can do once they are authorized access and authorized to input account adjustments.

The review indicated that IRS' internal security program had identified instances of employee attempts to embezzle funds by using the IDRS system.

With the technology available today, unauthorized access to taxpayer accounts can be restricted by systems controls. IRS' 1993 Action Plan to address security weaknesses within the IDRS system is attempting to move IRS in this direction.

For example, IRS reports that it now can use system controls to detect and intervene if employees attempt to access their own accounts or those of their spouses. However, similar restrictions have not yet been implemented to control employee access to the accounts of others, such as neighbors or relatives.

IRS also needs effective systems controls to not only restrict access to necessary taxpayer accounts, but to record audit trails of virtually everything that goes on with taxpayer accounts, so that actions taken by employees can be monitored. Such reports are planned as part of the new Electronic Audit Research Log system, but are not yet in place.

IRS has also taken steps to better inform and educate employees on their responsibilities concerning IDRS security and privacy issues. These steps have included distributing articles in newsletters, showing videos, recording a message from the Commissioner, all of which emphasize IRS' policy regarding proper use of taxpayer data.

Again, what is important is that this path of progress continues to be pursued.

Let me conclude with just a few remarks about computer systems security, generally. We will shortly report to this Committee on the results of our review of IRS' information systems security review which we undertook as part of this year's financial audit of IRS. Overall, IRS computer controls do not yet adequately assure that taxpayer data is properly protected from unauthorized access, unauthorized change, unauthorized disclosure or loss.

We found in particular the following principal weaknesses: inadequate control over access to computer systems; limited monitoring of taxpayer account transactions; poor contingency preparation for recovery after a disaster; and improper management of software changes.

None of these findings is new to the IRS. In its 1993 Federal Managers Financial Integrity Act report, IRS added security over taxpayer data as one of its material weaknesses. Over the last several years, IRS has commissioned a number of studies which have revealed these and other serious systems security problems.

Resolving some of these longstanding computer security problems is important, and IRS is moving in that direction. But until the solutions are actually in place, serious risks will remain.

And IRS does have in place a number of efforts to improve controls over access to taxpayer records. However, as I said, results are still limited. Much of what IRS considers as a solution to its computer security problems is embedded in the Tax Systems Modernization efforts, which is 6 or more years away from completion.

In our judgment, however, today's risks cannot be left to a future system to resolve. There are actions that need to be taken today to secure IRS' computer systems.

Mr. Chairman, IRS is working to better control electronic filings and the great risk of unauthorized access to taxpayer account data, and to improve overall computer systems security. Adequately reducing the risk in these areas will depend on effective and timely implementation by IRS of significant improvements. We believe the continued oversight and support of this Committee in tackling this challenge will be important to that effort.

This concludes my statement. We would, of course, be happy to answer any questions you or your colleagues may have.

Chairman GLENN. Thank you. We will wait on that until after Commissioner Richardson has presented her testimony.

Ms. Richardson.

TESTIMONY OF MARGARET MILNER RICHARDSON,[1] COMMISSIONER, INTERNAL REVENUE SERVICE, ACCOMPANIED BY MIKE DOLAN, DEPUTY COMMISSIONER; TED BROWN, REFUND FRAUD EXECUTIVE; HANK PHILCOX, CHIEF INFORMATION OFFICER; AND LARRY WESTFALL, MODERNIZATION EXECUTIVE

Ms. RICHARDSON. Thank you, Mr. Chairman.

I, too, have a longer statement that I would like to have submitted for the record.

Chairman GLENN. It will be included in the record.

Ms. RICHARDSON. Mr. Chairman, and other distinguished members of this Committee, I have with me today Mike Dolan, who is the Deputy Commissioner, and Ted Brown, who is our Refund Fraud Executive and was formerly the Assistant Regional Commissioner for Criminal Investigation for the Central Region.

I also have with me—but we did not have room at the table—our Chief Information Officer, Hank Philcox, and Larry Westfall, who is our Modernization Executive and is responsible for the Tax Systems Modernization integration with our operations and making the whole system work. So if you have any specific questions later of them, I hope they will be able to participate as well.

Chairman GLENN. Fine. Thank you.

Ms. RICHARDSON. We appreciate the opportunity to be here today to discuss the Internal Revenue Service's commitment to detecting and preventing attempts to undermine our tax system of voluntary compliance by those who are unwilling to comply with the tax laws. Our goal is to maintain a balanced enforcement program that ensures compliance among all groups of taxpayers, while safeguarding taxpayers' rights and privacy.

We are also appreciative of the opportunity to update you on our progress since last year's hearing in safeguarding taxpayer files from unauthorized access and manipulation.

Today, I would like to share with your our current activities and our longer-term strategies for addressing tax refund fraud, which is merely one element of tax fraud.

Both the electronic and the paper filing systems are subject to continuous attempts by "fraudsters" to circumvent fraud control mechanisms that we have installed. Our initiatives are and will be directed at protecting both the electronic and the paper filing sys-

[1] The prepared statement of Ms. Richardson appears on page 74.

tems, since both are exposed to yearly fraud attempts. However, and I cannot say this strongly enough—only when we have been able to implement our Tax Systems Modernization program will the IRS acquire the computing systems in the capacity that we need to install the sophisticated fraud control mechanisms that will prevent fraudulent refund claims and also will allow us to lock out all unauthorized activities in our system.

Mr. Chairman, fraud, as you know, is not unique to the Government or to the Internal Revenue Services. Technological advances have significantly improved both public and private institutions' capacities to deliver money faster. Prompt payment is a desirable customer service goal, but for an agency like the IRS, it presents problems from a law enforcement standpoint. Efforts to shorten payment cycles and to dispatch electronic payments rapidly must be matched by corresponding safeguards to ensure adequate controls. While we very much want to provide a quality service that includes prompt payment, and we are moving toward this through modernizing our technology, we have to ensure the integrity of tax administration and be concerned about improved compliance as well.

Since 1977, we have addressed tax refund fraud through our Questionable Refund Program. That program, which was conducted in each of our 10 service centers, had teams of trained personnel to review pre-refund tax returns which had been selected manually, or selected based on computer criteria. In response to a number of factors and emerging trends, we have designed a new fraud reduction strategy which utilizes new technology and multifunctional resources to control fraud.

Our fraud reduction strategy encompasses attempts to understand fraud as well as to prevent, detect, and bring enforcement actions against those who are caught. We believe that all four of these elements are essential for effective fraud control.

These increased efforts from 1990 to the present have resulted in significantly more fraud identified and stopped by the IRS as well as our ability to identify a number of new schemes. Before detailing the strategy, though, I want to briefly touch on some of our research efforts in the filing fraud area.

As I said, understanding fraud is a very important part of trying to detect and prevent it, but it is not always easy to understand all of the schemes. The statistics that are readily available have limited value because they are taken from existing fraud detection operations and obviously cannot include undetected fraud.

The level of detected fraud has increased, as you all have noted. This increased rate results from improvements in our detection capabilities and, though we cannot be sure, probably some increase in fraud attempts.

To enable a more comprehensive analysis of the extent of refund fraud, we initiated three studies during this past filing season. The first study has been completed. That study involved the selection of a statistically valid sample of approximately 1,000 returns which were filed electronically during January of this year. Each of these returns claimed the Earned Income Tax Credit.

The Earned Income Tax Credit claim was verified by IRS special agents, by going out and personally contacting taxpayers, tax re-

turn preparers, and employers. That study showed that roughly 35 to 45 percent of the 1.3 million Earned Income Tax Credit claims filed electronically through the end of January would, because of the errors involved, have been adjusted by either increasing or decreasing the credit claimed if they had been subject to a full examination. These percentages of error may be understated because 18 percent of the EITC returns that were filed electronically were rejected before they were filed, due to some improved fraud detection measures we had installed at the front end of our system.

About one-half, or 50 percent, of the EITC claims with errors appear to be the result of unintentional errors—oversights and all kinds of mistakes that are made. The errors remaining on the other half appear to have resulted from intentional misrepresentations, based on our assessment of the taxpayers.

The additional characteristics that we have derived from this study are going to assist us, and have assisted us already, in identifying potentially fraudulent claims, and from there, help us to develop additional fraud controls for next filing season.

Our fraud reduction strategy. Again, shortly after I became Commissioner, when I realized that we desperately needed to step up our efforts to detect refund fraud, I responded in two significant ways. First, we engaged the services of the Los Alamos national Laboratory—something I want to come back to in a few minutes—and second, perhaps more significantly, we appointed Ted Brown, who is with me today, to spearhead our enhanced efforts.

Mr. Brown has 22 years of experience in our Criminal Investigation function and a strong background in fraud detection. In his new role, he is responsible to me and to the Deputy for developing and overseeing all of the IRS' efforts to enhance the detection and prevention of not only refund fraud, but also filing fraud in general.

But controlling fraud is a dynamic undertaking. Fraud is perpetrated by those who think creatively, adapt continuously, and frankly, relish devising complex strategies. Fraud prevention mechanisms which are perfectly satisfactory today may be of no use tomorrow.

Therefore, to maintain effective fraud prevention mechanisms demands continuous assessment of emerging trends and constant revision of the current prevention mechanisms. Our goal is to stop fraudulent returns from entering the system. Although detection and prosecution are important, after the fact enforcement is costly and inefficient; prevention is the key.

We have been and we will continue to institute short-term changes designed to prevent fraud. However, the long-term solution to fraud prevention really does require the enhanced capabilities of our Tax Systems Modernization program. But we understand that combatting fraud requires not only systemic changes, but also the combined efforts and continuing support of all of our partners in tax administration—tax return preparers, tax practitioners, and the Congress.

As I mentioned before, I recognized that fraud detection was a priority item when I became Commissioner, and to that end we needed to improve our current screening and detection systems with more sophisticated and automated techniques. With key members of my staff, I visited Los Alamos national Laboratories to see

first-hand the creative use of artificial intelligence systems in detecting fraud. We have engaged the services of Los Alamos and now are able to bring to bear the resources of the world's most powerful, high-performance computers to help us in fraud detection.

While the Laboratory's research with nuclear weapons is widely known, in recent years, it has assisted many agencies in improving computer security and in designing software to detect anomalies and match patterns in large data sets. We believe their assistance will improve our ability to identify fraudulent refund claims and to reduce expensive manual screening procedures.

As we continue to identify the items on returns that are predictive of fraud, we will move those filters to the front of our processing system. Returns with these patterns can then be removed from normal processing and carefully scrutinized.

For the 1995 filing season, we will install a new electronic fraud detection system which will serve as a platform for the Los Alamos Laboratory systems.

Our detection capabilities have also been enhanced through the efforts of our Internal Audit function. Our Chief Inspector views refund fraud as a priority and has made it a significant piece of the Internal Audit work plans. Beginning with the 1994 filing season, Internal Audit began devoting substantially more resources to evaluating the efficiency and effectiveness of our fraud detection mechanisms. Internal Audit's intensified efforts will continue through the 1995 filing season.

As I mentioned before, our current detection program depends on a pre-refund review of millions of returns selected either manually or by computer criteria. Those returns having substantial indications of fraud are then referred to field offices for possible criminal investigation. The detection criteria are dynamic, and they are developed and refined to respond to identified false claims and abuses.

In addition, the overall processing of returns by the IRS has certain built-in checks and balances to assist us in the identification of suspected fraudulent claims. Throughout the returns processing pipeline, trained Service Center personnel designate suspicious returns for review by our Questionable Refund Program teams. Internal as well as external sources of information are used to identify fraudulent returns. Additional staffing this year has allowed our Questionable Refund Program teams to review more returns and to use a more analytical approach in the detection process. Our returns processing and information systems functions are continuing to expand their role in fraud detection, and I think that has also contributed significantly to the increase in the detection of fraud.

The fourth component of our fraud reduction strategy involves the use of enforcement tools, such as prosecution, to deter criminal violations of the tax law. Public confidence in our tax system can only be maintained if tax refund fraud perpetrators know that they risk going to jail if they are caught. The IRS, working with the Department of Justice and with U.S. Attorneys, will continue to actively pursue cases of criminal violation of the tax laws, with every intention of prosecuting where appropriate.

Our criminal enforcement efforts have been very successful, with approximately 98 percent of the indictments involving refund fraud

resulting in conviction, and the average incarceration time has been 17 months.

But despite our successes, we recognize that we cannot prosecute the problem of fraud away and we must have a broader, multifunctional fraud reduction strategy. In continuing our effort to reduce tax refund fraud, we made numerous systemic verifications that we implemented in the 1994 filing season.

These included additional comparisons of IRS data to confirm the identity of taxpayers and the validity of their claims. However, we do not feel it would be appropriate to disclose the specific nature of those checks here, since to do so would reduce their effectiveness in protecting our system.

While it would also not be appropriate for me to discuss all of our fraud control measures for the 1995 filing season, there are two actions which I want to share with you today. One, we are tightening standards for the electronic return originators (EROs). New standards under consideration include requiring first-time EROs, as they are called, to submit fingerprints to us and allow us to obtain criminal checks from the FBI.

Chairman GLENN. And "ERC" is another way of saying a person filing?

Ms. RICHARDSON. Well, no. This is actually an "electronic return originator," the intermediary between the taxpayer and the preparer.

Chairman GLENN. So it would be like the tax preparer, who submits on behalf of a person?

Ms. RICHARDSON. Yes, they actually provide the system to file the return. They do not necessarily prepare the return, but they have the software and the compatible hardware to file the return.

Chairman GLENN. Thank you.

Ms. RICHARDSON. But up until now, and I know GAO has recommended in the past that we engage in criminal background checks. We will be doing that for the 1995 filing season—working with the FBI. They have been most helpful in helping us set up the program for next year.

We are also going to conduct credit checks of these people for next year before they are allowed to be part of our electronic filing program.

Also additional field resources are going to be shifted into compliance checks of the whole electronic return originator community, and enforcement of the requirements for participation in the program will be stepped up.

Second, substantial efforts are going to be devoted to assuring that taxpayers who are claiming refunds are using their proper Taxpayer Identification Number. To that end, we are planning to direct significant resources toward identifying refund claims without a Taxpayer Identification Number, with an invalid Taxpayer Identification Number, and/or where they are using duplicate Taxpayer Identification Numbers.

Today, if you want to withdraw money from a financial institution using your card, you have to use the proper account number or the proper PIN number. We believe that before money is paid from the Federal Treasury, the taxpayer should also have to provide a correct, valid Taxpayer Identification Number. Failure to do

so next year is going to result in the delay of the refund until we can get the matter resolved.

As this Committee is aware, at the behest of the House Ways and Means Committee, a Treasury Department Task Force was formed to study tax refund fraud. The Undersecretary for Law Enforcement, Ron Noble, is chairing that effort. We are participating in this effort and plan to submit the findings in September to the Ways and Means Committee, but we will look forward to sharing those findings with this Committee as well.

Chairman GLENN. Good; we appreciate that.

Ms. RICHARDSON. The actions that I have just outlined are, we believe, significant steps we are undertaking to detect and prevent fraudulent refund claims. However, Tax Systems Modernization (TSM), which we are implementing over a period of years, really does hold the key to identifying and stopping those who attempt to fraudulently circumvent the tax system. Without modern equipment and software, methods of applying expert systems analysis to large databases is virtually impossible.

TSM will not only provide the computing power and the capacity needed to apply sophisticated fraud detection techniques, but will also provide us with more timely access to more information needed for compliance, thus enhancing our ability to collect the proper amount of taxes.

Systems we install this year and in the next few years—or, at least, hopefully, we will be installing—will permit us to capture all of the information on paper tax returns compared with the 40 percent that we are able to capture today through our labor-intensive manual input process, where we have data entry clerks literally transcribing the data on the face of returns.

This ability to process paper returns through electronic means will enhance our ability to identify fraudulent returns by enabling systemic cross-checking of more information on the return, as well as with other returns. Other features will improve our ability to perform more validity checks and data analysis work. These changes will have an enormous impact in enabling us to detect and stop fraud before it takes place.

Through these and other TSM projects, the IRS will be able to make dramatic improvements in tax administration and significant inroads in our fight against fraud. Such significant inroads cannot be made, however, if funding for these projects is delayed or not available.

Mr. Chairman, while I appreciate the difficult financial choices that Congress has to make concerning the fiscal year 1995 appropriations bills—and I must say we thank you very much for your support and that of Chairman Sasser in the budget process—we do feel strongly about the need for more funding for the TSM effort for fiscal year 1995. Unfortunately, as of today, significant reductions in TSM funding for fiscal year 1995 do appear to be likely. Such reductions, unless they are largely restored, may require us to stop all of our major hardware acquisitions we had planned and consequently rethink completely the Tax Systems Modernization program that we had planned.

Since the hearing in August last year before this Committee, as you know, there has been ongoing dialogue and numerous meetings

between our staffs, as well as several meetings that I have held with you, to discuss what steps we have taken to improve our control of unauthorized access to taxpayer information and also to promote our concerns about privacy. We have taken numerous steps to increase the protection afforded to taxpayer information. We have now got an Advocate for Privacy, and we have done a lot of things to prevent privacy abuses in the future. We have announced penalties on those who commit such abuses, and we have designed and developed more efficient information systems to identify such abuses, as well as planned for the development of future TSM systems that will prevent abuses from occurring at all.

I recently appointed Robert Veeder as the Privacy Advocate for the IRS, and he is also here with us today. Mr. Veeder has worked extensively with the Privacy Act and the Freedom of Information Act as a senior policy analyst at OMB. In his new role, he has the responsibility for developing and overseeing the Service-wide privacy program as it relates to or is impacted by initiatives proposed by Congress, other agencies, and the public. Recently, Mr. Chairman, this new office, as part of its Service-wide outreach and training programs, developed a privacy information video featuring you and Senator Pryor that has now been distributed to all district, regional, and service center training offices. By the end of this fiscal year, it will have been viewed by all IRS employees.

As you know, after last year's hearing, we developed an Action Plan which covered 35 critical areas aimed at improving both the security and privacy of tax information in our IDRS database. As you are aware from the ongoing dialogue and our status reports, as of July this year, we have completed 21 of those actions, nine are on schedule to be completed, and five we have had to reschedule.

Some of the major accomplishments of the Action Plan include a policy statement on privacy rights which I issued to all employees, which emphasizes the need to protect taxpayers from unnecessary intrusion into their tax records, and 10 basic privacy principles to establish a public trust for protecting taxpayer privacy, and safeguarding the confidentiality of taxpayer information were also enumerated. These principles were distributed to all employees and are being discussed in employee group meetings throughout the Service.

We issued a Guide for Penalty Determinations that lists penalties for the various types of misconduct; that also have been issued to all employees, with the goal of assuring that we will not have inconsistent treatment and inconsistent penalties for misconduct in this area.

We have also installed an Electronic Audit Research Log (EARL) system in all service centers in March, and that is going to provide searches of the IDRS audit trail for security and staff management.

As you, Mr. Chairman, have recognized, the systemic solution to safeguarding taxpayer information is also found in TSM. Without that system, we will not be able to provide State of the art security and privacy protection for taxpayer information.

I would like to conclude by saying that prevention and deterrence are clearly keys to refund fraud control. Prosecutions are an important component of our strategy, and we are going to continue to

emphasize enforcement. Our deterrents and our detection programs are working, but I think we all agree that we need to enhance them so we can continue to detect new schemes. But we need the help of all of our partners in tax administration to recognize that fraud reduction is a joint responsibility.

We also recognize that fraud detection may necessitate the slowing down of the refund process in some cases. Mr. Chairman, we will need your understanding and that of your colleagues so that further streamlining of the refund process, especially with respect to motor fuel excise tax claims and other refundable credits, can sometimes seriously jeopardize our efforts to detect and prevent fraud.

With the assistance of you and your Committee, doing whatever it can to obtain our fiscal year 1995 funding, we are optimistic that we can continue on track with Tax Systems Modernization and that we will therein be able to enhance our fraud detection efforts as well as enhance our privacy and security efforts.

That concludes my statement, and we would be more than happy to answer any of your questions.

Chairman GLENN. Thank you very much.

I will start with Mr. Hinchman. Mr. Hinchman, in your look at this, do you think we are getting better detection, or is there really more fraud out there? Can you break that down for us?

Mr. HINCHMAN. I think, as the Commissioner just said, we really do not know the answer to that question. There is really no empirical basis for reaching a judgment on that question.

As we understand it, the IRS does have underway several studies which are going to try to provide that empirical base, and will be able to reach some judgment about that.

There have been suggestions from time to time that we look at fraud detection in other financial sectors, like credit cards, for example, or bank transactions. The difficulty with that is that each of these sectors has its own characteristics in terms of the people who are involved and the kinds of activities that are going on, and I do not think there is any substitute for the empirical information which IRS is now collecting.

Chairman GLENN. Good. What is your opinion, Ms. Richardson? Do you have any idea on this? What I am thinking about is a little bigger philosophical problem. Is all this cynicism of Government meaning that people are more prone now to try to hold back on taxes and not be honest on their tax returns? Has it gone that far, or is it just that we are doing better detection on what has been there all along?

Ms. RICHARDSON. I think in large part, it is our ability to detect fraud. I think the irony is that the electronic filing system and electronic processing of information has allowed us to detect patterns and do things that we were never able to do before.

So I think probably, in large part, it is our enhanced detection ability, but there may be additional fraudulent schemes out there as well.

Mr. HINCHMAN. And obviously, we all hope that the problem is only—if that is the right word—better detection. One of the reasons to do these studies is that we will get that answer, and if the an-

swer is that the rate of fraud is in fact not increasing, we will all sleep better.

Chairman GLENN. We hope.

Mr. Hinchman, in previous testimony, you and other people from GAO have testified that they felt IRS might be more interested in pursuing modernization and that this is being pursued too fast and it is a detriment to systems security and growing fraud. Do you think that is still valid?

Mr. HINCHMAN. Back in 1989, when the IRS had an experimental system for electronic filing, we issued a report in which we urged that before that system be implemented Nationwide, there be a fresh study of the requirements of such a Nationwide system. We said that we thought that this experimental system was never intended to be rolled-out for production.

Obviously, one of the things that needed to be tested was the question of whether the system had adequate security built into it. That advice was not taken. That experimental system was implemented Nationwide. And I think to some extent, ever since, we have been trying to catch up; we have been moving from fire to fire, trying to keep the security problems in the system under control. And I have already said that we are very supportive of the innumerable efforts that Commissioner Richardson and her staff have underway to do just that. But in the final analysis, until we step back and get a comprehensive assessment of what the security needs are for a Nationwide electronic filing system, we are not going to get this problem under control. That means we need to be as concerned about security as we are about speed and all the other things we get from electronic filing.

Chairman GLENN. Let me follow up on that just a little bit. It seems to me that we have been pushing this idea of speedy returns and fast refunds, and loans—they are termed "refund anticipation loans"—paid when the IRS issues the actual refund. And we transmit back direct deposit indicators and so on to guarantee that the refund will be there in 2 weeks.

What is the requirement for all the speed? It seems to me that that is where all the fraud is coming into this thing. Why are we trying to do this so fast? It seems to me we may be emphasizing speed—I guess I would ask this of Ms. Richardson. Why are we pushing speed where that seems to get us off-base?

Last year, IRS was able to stop just about 54 percent of refund checks where it detected fraudulent electronic returns, and that is $25 million in bogus refund checks; and another $10 million in bogus refunds sent out on fraudulent paper returns.

I know it is nice to get people their money back, but do we need to do it so fast that we are losing money on it? It seems to me we would be ahead to slow up a bit and make sure of what we are doing.

Ms. RICHARDSON. Well, I fully agree with you, and that is why for 1995, where we have questionable situations, we plan to delay the refunds until we can verify that taxpayers are actually entitled to them.

There is an inherent conflict, I think, between better customer service, faster customer service, the kind of access and quick responsiveness that many people have come to expect in the private

sector, and what they would like from their Government—the law enforcement and the tax administration needs to install these checks so we will be able to review the refunds to prevent the fraud.

I fully concur with you, Mr. Chairman, that we cannot value speed over the accuracy of the refunds.

Chairman GLENN. The Earned Income Tax Credit appears to be a very significant element in filing fraud. In fact, your written testimony discloses in a recent sample IRS found that 50 percent of returns with errors related to the Earned Income Tax Credit may have been fraudulent. Fifty percent I think was the figure, and I think you gave that figure a little while ago.

Is this that people are just out to gyp the system, or do they not know how many kids they have, or what is the problem here? The Earned Income Tax Credit seems to me to be pretty straightforward, and it would be difficult to fudge that one and get a fraudulent return on it. What is the problem there?

Ms. RICHARDSON. I think our testimony was that probably around half, (or somewhere between 35 and 45 percent) of the returns that we surveyed had claimed the Earned Income Tax Credit and would have been adjusted if we had given a full examination of those returns. Some of those were errors that were against the taxpayer, but many of them were not. Probably half of them were from intentional errors. I would also say that the Earned Income Tax Credit is a fairly complicated process. The rules were changed last year, and it was expanded to include several different filing statuses, so that made it a little bit more complicated.

But I think there is no question where you have refundable credits, an opportunity for fast money, that you promote the opportunity for fraudsters to get involved. I think that is true in the private sector as well as in the public sector.

Chairman GLENN. Thank you. My time is up on this round.

Senator Dorgan.

Senator DORGAN. Mr. Chairman, thank you very much.

I would like to ask a couple of questions similar to those I asked last August about what is the penalty. What would a person who now is employed by the IRS expect to have happen to him or her if they were caught snooping or browsing or disclosing in an unauthorized way information on a tax return? In the GAO report, they indicated that of the 328 cases that they discussed with us last fall, they were not able to get information on some 32 cases—that is, disposition and evaluate whether the disposition was appropriate—but of those they did get information on, in 51 of the disciplinary actions, they found that the IRS was too lenient. That would mean that the Internal Revenue Service management, in one of five or one of every six cases, has made a disposition with respect to the employee's actions that the Office of Ethics concluded was too lenient.

Can you tell me how you feel the actions by the IRS were? Do you agree with the Office of Ethics that the IRS was too lenient? And if so, what has been done to be sure that in the future, we are not going to see the management of the IRS impose penalties that are too lenient once again?

The reason I ask the question is if you do not have a system in place that says to employees in the IRS: Do not even think about this—not only do not dare, but do not even think about unauthorized disclosure; do not even think about browsing, and do not even think about snooping, because the penalties are certain, severe and harsh—I worry when the GAO tells us one in five or one in six cases were cases where the penalties applied by the management were too lenient—why?

Ms. RICHARDSON. I recall you had a sign that you offered us last year——

Senator DORGAN. I told you of a sign at a motel in Minneapolis where the manager parked that said: "Do not even think about parking in this space."

Ms. RICHARDSON. And I will tell you that I have used that in many visits with employees to remind them not even to think about abusing taxpayers' rights to privacy.

To answer your question about unauthorized disclosure, there are criminal and civil penalties that can be imposed for unauthorized disclosures of tax return information, and fortunately, it happens very rarely, but we do treat those cases very seriously, and we refer them to the Department of Justice for prosecution where there have been unauthorized disclosures.

Most of the cases we discussed last year, the so-called browsing cases, did not involve unauthorized disclosures outside the Internal Revenue Service; they involved employees who were authorized to be in the system, but they were not authorized to be looking at the accounts that they were looking at. In other words, if they were authorized to look at your account, Senator Dorgan, and they looked at Senator Sasser's, they were not supposed to have been doing that.

So what we did was we issued a table of penalties—it was our Office of Ethics that made that review, and we arrived at the conclusion that in 51 cases, the penalties were too lenient. GAO concurred in what we found, I believe——

Mr. HINCHMAN. That is correct.

Ms. RICHARDSON [continuing]. But it was actually our finding. So I do agree that we were too lenient. IRS management agrees with that.

Senator DORGAN. But my question is how did that happen. I guess I would prefer that you come out in a manner that suggests that the penalties were appropriate, rather than too lenient.

Ms. RICHARDSON. Well, I cannot tell you how it happened in every specific case. I can tell you that until approximately a year ago, we had not placed the emphasis that I think we should have on the whole issue. We have since taken great steps to educate every, single employee about what their obligations are. We have made it very clear that dismissal is one of the penalties that can occur for the browsing, not just the unauthorized disclosure. And we have issued a Table of Penalties, so that across the country, uniformity can be applied in these cases.

One of the problems in an organization of 115,000 people that is highly decentralized—or it has been, historically—is that you do find inconsistent treatment in various parts of the country. I think we have made great strides. We have met with the regional com-

missioners, our district directors, and we have made it very clear we take the matter seriously, and we take the issue of the penalties very seriously.

I would hope that if we were to have a similar review today of the matters—and some of these had occurred in earlier years; it was not something that just happened in this past year—that we would not have the same conclusion, that we would agree that appropriate penalties had been imposed.

Senator DORGAN. But the report says today that more of this is occurring. And the question for someone who now works at the Service is what is going to happen to them. Let us assume that they want to take a look at Senator Glenn's tax return just because it would be fun. He is a fairly famous American——

Chairman GLENN. Pick somebody else, would you? [Laughter.]

Senator DORGAN [continuing]. And they have, among 50,000 others, access to a code and might browse and take a look at that tax return, or Senator Sasser's, for that matter. And who knows what they would do with that information, but they did not need it; they were browsing and snooping and may or may not, in idle conversation, give a snippet of it to someone.

I would prefer that someone view your action later on as being too tough rather than too lenient. Obviously, we want you to be fair, but if there is a criticism, I prefer the IRS be criticized for being too tough, and where somebody says, "They are tougher than nails down there; there is zero tolerance for someone who abuses this information."

Ms. RICHARDSON. I concur in your view, and I hope that if we have another review, and if we have erred on one side, that we have erred on the side of being too tough, because we do have zero tolerance for that kind of activity.

I think the increase in numbers we need to focus on—and I will let Mr. Dolan address some of the specifics. When we were here last year, we were reviewing a report from one of our seven regions. We just instituted a review of the browsing issue in the Southeast Region. What we have done since that time is to look at all the regions, as we agreed we would do at the hearing; we just did not have all of the software or plans in place to do it. That is where the additional numbers have come from over the past year. So what we were talking about last year was one of the seven regions.

Chairman GLENN. Senator Sasser.

Senator SASSER. Thank you very much, Mr. Chairman.

Commissioner Richardson, the instances of fraudulent returns filed electronically involving the Earned Income Tax Credit appear to me to be very high, based on your testimony and what the General Accounting Office has told us. Now, the Earned Income Tax Credit applies predominantly to people of low income, and they do not have the means themselves to file an income tax electronically; they are going to tax preparers, are they not?

Ms. RICHARDSON. They are.

Senator SASSER. Well, I am wondering if there has been any—and perhaps I ought to address this to Mr. Hinchman—but has there been any investigation to see whether or not these tax preparers are encouraging people to give them fraudulent information

so that they can say, well, if you will come to us to get your return prepared, we are going to get you a refund, and that spreads through the neighborhood, and before you know it, everybody is in there wanting to get a refund, and the professional tax preparer, who has the capability to do it electronically and get a swift return, is encouraging data coming from the taxpayer that will get the tax return that the tax preparer said he could get for them.

Ms. RICHARDSON. I would like to say that we feel the vast majority of the people who prepare returns are honest and do so in accordance with the law. But there is no question there is an unscrupulous element out there that is trying to prey on people who frequently do not realize that they are being taken advantage of.

I mentioned we were doing three studies during the filing season. One of the studies—and I would like Mr. Brown to elaborate on it a little bit—has been focused on the electronic return originators, and some of the steps we are taking next year will be aimed at trying to get the unscrupulous people out of the system.

Mr. BROWN. Senator Sasser, we did a study of electronic return originators (EROs), and we pulled a sample of approximately 2,000 returns that came in through the electronic system, mailed out correspondence looking for adjusted refunds or other types of preparer misconduct involved in those claims. We have about 60 percent response rate at present, and in that, there is very small indication of even a minor problem of difference of opinion between the preparer and the taxpayer.

We are now following up on the 40 percent whom we did not hear back from, which obviously offers the greatest potential; they would not answer us if they were involved in a fraud scheme.

We have also done other studies of EROs in an Internal Audit project, looking at ways to identify ERO misconduct. We will be implementing parts of that next filing season. So we are concerned about that and are building in systemic checks to look for that pattern of activity.

But I would also mention we have had a problem with non-preparers—recruiters, if you will—who move into the community and try to solicit other taxpayers to file fraudulent EITC claims; and they are not tax professionals, but are criminal recruiters who try to enlist people as well.

Senator SASSER. What is their motive for enlisting people?

Mr. BROWN. Usually, they take the money. They will go to a taxpayer or move to a neighborhood and ask, "Do you have a Social Security Number?" and if you do, then they will prepare the bogus documentation, and what they will give you is $400 or $500, and they will keep the $1,000, $1,500 or $2,000 that is developed through the scheme, from each one of those that they can solicit and recruit.

Senator SASSER. I think there is an incident that has been reported of tax preparers getting the Social Security Numbers from agricultural workers in California. I suppose these are migrant agricultural workers—or do you know?

Mr. BROWN. Both.

Senator SASSER. They file the return using a real Social Security Number, and once the return check comes back, the tax preparers

themselves are negotiating the checks—is that what occurred in that instance?

Mr. BROWN. You have both return preparers who are knowledgeable and get involved, and you have others who are unwitting accomplices. These people just show up with a prepared return and say, "I would like to file this electronically," and obtain the refund anticipation loan, and the tax preparer is not the wiser.

Senator SASSER. I think we are all aghast that there would be this browsing or snooping through people's tax returns by people who work for the Internal Revenue Service. I would like to kind of put this in perspective, however.

You were indicating you have 115,000 people who work for the Internal Revenue Service. How many people have been adjudicated guilty of illegal browsing through people's returns over the past, say, 3 years?

Mr. DOLAN. Senator Sasser, I think we had provided some information to staff that indicated that in 1991, 1992 and 1993, there were about 1,272 instances in which some action took place as a result of an unauthorized access.

Now, within the definition we were using of "browsing," browsing would be a subset of that, and I do not have that broken out as part of that 1,272. That is a 3-year period.

Senator Dorgan was earlier talking about being alarmed at the activity that appears to have happened subsequent to the August hearing of last year. And I think as the Commissioner pointed out, at that point, we said we were midstream, with a total of 18 projects that our internal audit activity had ongoing. From those 18 projects, we have gotten 525 additional cases referred; of those 525 cases, we are in the process of completing the analysis already, and I think 120 or so of those have fallen out as no action. Others will end up producing action. We expect to get 223 more cases from inspection, which will completely close out those 18 projects. So we will have a total of some 700-plus cases that will have been in many cases transgressions that might have occurred, actually prior to the last August hearing—some subsequent, but at that point, the universe of before the raising of the bar. We really believe, as a result of all the activities the Commissioner has enumerated, that we have tried very hard to raise the bar, tried very hard to place the exhortation, "Do not even think about it," tried very hard to the extent that there were inconsistencies to reverse those inconsistencies; but in the meantime, we will add to those 1,300.

Now, the good news, if there is good news, one of the other things we have gone back in and done is we have looked for repeats. We have looked to see have people gotten or not gotten the message when they have been called to task before. And there something below 2 percent of the people who show up in here that have ever shown up before. So we are heartened by the notion that people have gotten the message and have not made the mistake twice.

Senator SASSER. My time has expired.

Thank you, Mr. Chairman.

Chairman GLENN. Thank you, Senator Sasser.

Senator Cohen.

Senator COHEN. Thank you, Mr. Chairman.

Ms. Richardson, Mr. Hinchman, ordinarily, when the Permanent Subcommittee on Investigations conducts investigations into large-scale operations of defrauding the Government, we find a pattern of activity, with, number one, a large amount of activity involved; there is little chance of detection of the operation, little chance of prosecution, little chance of conviction, and ultimately, little chance of incarceration. We find that to be the pattern in most of the cases we investigate.

There would seem to be an exception when we are talking about the IRS. The question about detection remains an open one in my mind. But once you do detect it, you seem to have a fairly high conviction rate.

Are the penalties sufficient to serve as an adequate deterrent as they currently exist in the law?

Mr. BROWN. I would think so, Senator. The Title XVIII False Claims Statutes, 286 and 287, are the primary vehicles that we use to prosecute false claims, and they are both felonies with substantial jail time. And even within the Sentencing Guidelines, as the amounts of money are large, with many participants, then, as we said, we get an average jail time of 17 months. So I think we have also been successful there, and getting people in jail when it is appropriate.

So my reaction is they are adequate.

Senator COHEN. I believe Senator Glenn has talked about this 2-week promise that is made, sort of competing with Domino's Pizza—if you get it in electronically, we will get it to you in 2 weeks, or else we pay the cost, and it goes on us——

Ms. RICHARDSON. It is not a promise, I will say that.

Senator COHEN. And I understand the incentive we want to have with electronic filing because it cuts down on the manpower that is necessary to check it manually.

But if the 2-week period right now is causing, or contributing, according to Mr. Hinchman, to the problems of increased fraud, what would be a more reasonable time frame, Mr. Hinchman?

Mr. HINCHMAN. I think our own view is that it is not so much that the time frame ought to be extended as that the same electronic systems that make it possible to meet that time frame also need to be used to prevent fraud in the system. There needs to be greater reliance on electronic screening of returns, for example, as opposed to manual screening. And we know that the IRS is trying to move in that direction, but they are not there.

Senator COHEN. In view of the fact that they are not there yet, what do you recommend? In other words, it is not the question of the 2-week period, but of not having the computer capability at this particular point. So in the absence of that capability right now—and I will get to the modernization systems in a moment—but in the absence of that technology right now, what is a reasonable time frame?

Mr. HINCHMAN. We have suggested, for example, that refunds ought not be mailed until all of the steps necessary to assure, as best IRS can, that there is no fraud in the return have been completed. That may take an extra week; in some cases, it may take many weeks.

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Part of the problem with the losses in electronic returns is that in far more cases than paper returns, the refund is actually mailed before the fraud is discovered, and once that has happened, recovery is, I think it is fair to say, difficult.

I think the percentages, by the way, are something like 50 percent of refunds have been mailed before fraud is discovered in electronic returns; the number is only about 10 percent for paper returns.

Senator COHEN. Over the years, the GAO has been rather critical of the tax systems modernization effort, especially the IRS' failure to articulate a clear vision of what the modernization effort will do and what the requirements are. It has been 7 years now in the process of bringing this on line, and we have at least another 6 years to go.

Why is it taking so long to get some definition of the requirements and what the system will do?

Mr. HINCHMAN. I do not know precisely the reason for that. I think that we believe the capability exists today to design the system which will do what we, the IRS, everybody in this country, wants, which is to provide very fast, very accurate electronic processing of income tax returns.

What is required is the management attention to design all of the elements of that system, the guidelines and standards it is going to take, to begin putting that system together. That work is under way. Some work has been accomplished. I think that IRS now has a schedule for completing those guidelines and standards; I think it stretches into next year. And hopefully, we will keep to that scheduled and be prepared to go forward after that.

Senator COHEN. Is the price tag still $8 billion?

Ms. RICHARDSON. It is a net of around $8 billion. I would like also to have Larry Westfall, comment. He is our Modernization Executive and really responsible for making our Tax System Modernization plan work, bringing together the discipline we need to get this thing moving—if we have the funding. I would ask him to give you just a brief explanation.

Senator COHEN. Before he does that, let me ask the question, and then you can respond to it, Mr. Westfall. As I understand it, the cycle of computer technology now is roughly 18 months. That is how long it takes before new software is developed, and what has preceded it has become obsolete that quickly.

What do you have in mind for this Tax Modernization System to update itself and really be competitive with those who wish to defraud the system, who have access to the newest technology?

When GAO testified in 1991, they said you had 1950's era computer technology, and that may have been an exaggeration, but that was only 2 or 3 years ago, and I doubt very much whether you have made such giant strides to take yourself from the 1950's to the 1990's, but assuming that that has been done, how do you intend, given the kind of speed with which the software is now being developed and manufactured, to keep up with that?

Mr. WESTFALL. Senator Cohen, the overall Tax Systems Modernization effort is a long-term effort. It has built into it refresher clauses in which we transition over a number of years through different stages of technology to put the ultimate system in. So the

length of time is reflective of the fact that in transition, some pieces of the early phase technology and business changes around it are already in place, and that others will be staged in over time.

To make the point, in 1995, we had scheduled to make a major hardware acquisition called the Service Center Support System. That system will be the ultimate hardware platform that houses our on-line master file database for the future. If you look at this on a continuum, it is at the far end; it is the ultimate design or solution within TSM.

That acquisition has been in various stages of planning and execution for 5 years, and we are scheduled to make that buy in the spring of next year. It will then take us significant expenditures in software development to bring that system up to its full deployment; that will take place in the 1998 time frame. That is an example of the kinds of time frames that are tied up in an acquisition.

If you look at TSM in total, it is one of the largest deployments of business change, business re-engineering and technology I think that government in this country has ever experienced. So it is a very complex and important set of things that we are doing.

Ms. RICHARDSON. One of the things I think we also need to focus on is as we are bringing on this new equipment, we also have to keep the system running today. We do collect over $1 trillion in taxes, and we have to keep that system running as well. So we are trying to phase something in at the same time we are keeping our current business going.

Senator COHEN. Could I just ask one more question, Mr. Chairman?

Chairman GLENN. Go ahead.

Senator COHEN. GAO has cited the need to implement a control system that will identify all of the activity surrounding an account. For example, there would be some electronic fingerprints on the part of anyone who tried to access that account that would identify the employees. Do you have such a system in place now, or how far away are you from acquiring such a system?

Ms. RICHARDSON. We actually have in place today the ability to—any time an account is accessed, that is recorded, so that no one can go into or out of an account without it being recorded.

What we do not have the capability of doing today, at least on a broad-based basis, is locking people out of all accounts except the few that they might be authorized to work on or handle. We put in place I believe last fall the ability to lock people out of their own accounts and that of their spouses.

Senator COHEN. You cannot lock them out; they can get in, but do they——

Ms. RICHARDSON. Well, it actually freezes it. I believe if you go in and try to access your own account, it freezes up, and I think there is a supervisor who has to go in and unfreeze the account. You can no longer use the IDRS terminal until it is unlocked.

Mr. HINCHMAN. Senator, if I could add another point to what Commissioner Richardson said, it is not only important that the system record all of the actions that occur in an account. It is also critical that there be a system which can analyze those transactions. A printout of every action taken by any IRS employee over the last 24 hours is useless; nobody could go through it in the next

24 hours. What you need is software that can analyze that data, pull out meaningful instances that appear suspicious, reduced to a small enough number that a supervisor can do something responsible with it.

That is what is hard, and that is what has got to be done and what has got to be part of an adequate monitoring system.

Senator COHEN. Is that the artificial intelligence you were talking about before, that you are turning to Los Alamos for?

Mr. DOLAN. Well, we think there are some applications there, Senator, but the conversation we are having now is how to improve the control in our 1950's era environment. And we will concede that what we have in place now is at best a mid-term solution. The long-term solution is getting ahead of it, is having an automation system that allows you to profile the user much more dynamically. Currently we have 56,000 people today who have to use IDRS in the order of 10 million times a month doing something to somebody's account that they are supposed to do. And we do not have the capacity in our automated systems to be fluid or flexible in terms of profiling Mike Dolan for this kind of work and not for some other improper work. We have got to say Mike Dolan has these broad cuts, and those are the kinds of technologies and volumes we are working in today.

So our TSM solution envisions as the work comes to me in the future, it will come with parameters as to what I can or cannot do in that account, and what I cannot do with any other account like it. And that is built into our TSM design, but that is the future.

Senator COHEN. It is still 6 years away.

Mr. DOLAN. Maybe not a full six.

Ms. RICHARDSON. No.

Mr. WESTFALL. Senator, some of that will be staged as early as the late fall of this year. So there is transition in both security and privacy improvement that takes place as we stage through these next several years.

Ms. RICHARDSON. Senator Cohen, there is one additional point that I would like to add to the discussion of security with regard to TSM. TSM is certainly needed and critical, but we need to bear in mind that the security architecture for TSM—that is the set of guidelines that is going to describe what TSM will do with regard to security, and how it will do it. Those guidelines go to the project managers and directors who are building the systems. That architecture and those guidelines are not yet available and probably will not be available until the end of the year or sometime later this year.

So while we are talking about building TSM systems, with all of the safeguards built in, in fact there are development activities underway which do not have the benefit as yet of security architecture. So we just like to keep those points in mind as we talk about the imminence of TSM.

Chairman GLENN. Thank you. Let me follow up a bit on TSM—and I know we have other witnesses here this morning. But I will tell you that from our vantage point here, this TSM thing has been the darndest thing I have ever tried to lay a bead on. It is a moving target if I ever saw one. And I took over the Committee chairmanship in early 1987, and every year, we have IRS come up, and

every year IRS testifies, and I say, OK, what is your estimate on when you are going to have TSM in?

Well, it is going to be about 7 years.

The next year, I would come back and ask, well, now, when are we going to have TSM in?

Well, our latest estimate is about 7 years.

And this went on for about 4 years in a row. Now, I am very heartened this morning, because after only 7 years, we now have our estimate down to 6 years. [Laughter.]

Senator COHEN. But the cost has remained the same.

Chairman GLENN. The cost has remained the same. But by Washington standards, I guess that is major progress. So that sometime around the year 2025 or something like that, we will be down to 3 years or 2 years or something like that. So I guess we are making progress, but it sure is slow. And I do not know how we speed this thing up.

The first thing I know is to not cut your $400 million out of the budget this year, and we are working to try to do that. We have given every support for TSM I know how to do on this Committee, but it has been agonizingly slow. And I am also scared—as Senator Cohen said a moment ago, the computer software turns over about every 18 months, and I know one of these days, we are going to have a big change of software, because it is going to give us a new capability in the year 2025 or something, and then we will be back to the drawing board again. Somewhere we have got to get this thing in operation because we are sort of betwixt and between right now. The system is not good enough to work completely and do what we want it to do, and yet we are running into problems with automation and electronic filing and so on, and we need it, and I am left a little bit up in the air, I guess, as to exactly what we are going to do with this thing and when we can expect it.

I would hope we could shorten the 6 years down. I hope next year, you are bringing it down by double numbers instead of single numbers. But is there anything we can do to speed this thing up, other than just money?

Ms. RICHARDSON. Well, Mr. Chairman, I think that it is not 6 years. I think the 6 years is when we anticipate we will be completed, or pretty much completed.

I would like to have Mr. Westfall—I think he touched on the fact that we are planning a major acquisition in the spring of 1995. We are actually doing some things now, and a lot of TSM is really already with us, or will be, assuming we have the funding in the next 2 years. And I think you can be encouraged that it is not 6 years away; it is with us already.

Chairman GLENN. If you could respond briefly, because we are beginning to run out of time.

Mr. WESTFALL. Mr. Chairman, if I could just cite very quickly some examples of progress made to date, because much progress has been made. We have basically realized and declared to date approximately 5,000 staff-years in productivity, and that 5,000 staff-years has been removed from the IRS budget because of TSM implementation to date. That is through a series of projects that have made the resolution of accounts easier to our telephone-based personnel, giving them more information access. We have totally auto-

mated the matching program in our centers, and we have consolidated it from 10 centers into 5. We are on the verge of major rollouts of functionality in our examination and in our collection activities in 1995. By the way, that may be jeopardized by the budget mark in 1995.

There are, in fact, I assure you, substantial accomplishments that have been posted on the wall in progress we have made to date in improving our technology base and also business practices.

Chairman GLENN. Good.

Ms. RICHARDSON. I would also like to renew my invitation to you and to other members of the Committee to visit us, you particularly in our Cincinnati Service Center.

Chairman GLENN. I have been planning that visit for a long time.

Senator COHEN. On or before April 15th.

Ms. RICHARDSON. But I think you will be able to see the fruits of some of your labors.

Chairman GLENN. Let me follow up just a little bit on Senator Dorgan's comment about the parking space at the motel, which was very good. Obviously, I back him up completely in wanting you to be one tough Commissioner down there. And word should go out that whoever gets caught browsing or whatever they are doing, that is the end of the line. But do you need additional legislation to give you authority to really manage this thing? If so, we would be glad to go to work on it.

Ms. RICHARDSON. I do not think we do at this time. I think the important thing was getting the word out and making it very clear what our policy is.

Chairman GLENN. So you think you have all the authority you need?

Ms. RICHARDSON. I think we do right now.

Chairman GLENN. OK. One other thing we have not talked about yet. You had some cases where people actually went in and altered returns, and shared in the refunds, I believe. Could you tell us about that, and is that something that has expanded or is that stamped out completely now?

Mr. DOLAN. I think your reference is to some specific cases, Senator. If you would allow, I can provide you separately the closure on those cases. I do not have it with me at this moment in order to do that orally.

RESPONSE FOR CONGRESSIONAL TESTIMONY

In October 1993, we reported to the Committee that IRS Inspection Service investigators, in conjunction with their efforts on previous "REINF" Integrity Projects, had referred 22 cases to U.S. Attorneys for prosecutive determination. U.S. Attorney's accepted 13 of these investigtions, involving four employees and nine other individuals, for p rosecution. Prosecution of nine other employees was declined. These nine employees either were removed or resigned from the IRS.

As of August 31, 1994, three employees and nine other individuals have either plead guilty or were convicted of crimes involving fraudulent acts. One employee resigned from the IRS after being found not guilty by a jury.

Chairman GLENN. OK, but are we completely on top of that—because browsing is one thing, and prurient interest or window-peeping, whatever, is bad enough; but where people went in and actu-

ally altered returns, shared in refunds, that is high order of criminality.

Mr. DOLAN. Absolutely. We are on top of it in the sense of having dealt with what we identified. On an ongoing basis, though, our Chief Inspector has a series of projects where, systematically and continuously, we are exploring and examining for like patterns. We are not taking it for granted.

Chairman GLENN. OK.

Senator Cohen.

Senator COHEN. Yes, just one final question for the Commissioner as such. You mentioned in testimony before the House Ways and Means Committee, an oversight committee, back in February, I believe, that you had a program to estimate the extent of the fraud we are talking about. There was some ambiguity as to whether it is more fraud or more detection, and you were going to institute a program to determine the extent of the fraud. Number one, have you instituted the program, and if so, what is the progress of the program?

Ms. RICHARDSON. We have, and I mentioned that we had instituted—or, I think I summarized just one of the studies. We have three studies underway that Mr. Brown is heading up, and he might give an update as to where we are on each of the studies.

Mr. BROWN. We did do three studies this filing season, Senator. The first was the EITC study; the second was the ERO study, and third, we did a larger sample over the entire filing season on paper, which we are now doing some of the analysis on.

We are also building plans for next year to use statistical sampling to look for fraud. One of the challenges is if you try to look for fraud in the whole tax system, the numbers get so enormous that we could take our 115,000 employees and still not do enough sampling. So we have to pick particular vulnerabilities, whether that is the EITC or motor fuel or some other area that we identify, and then we have to go in and do studies so we can learn something about the fraud there. And then, the most important thing to me is we use that learning to improve our detection capability. We try to identify variables that are predictive of fraud or as importantly predictive of a valid return, so that we can pass these returns through the system, and much like the refund issue, good returns get their refunds quickly, and suspect returns get stopped until we can resolve them.

Senator COHEN. So that next year, when you come to testify before the Committee, you will be able to tell us whether it is more fraud or more detection?

Mr. BROWN. We will probably be able to tell you more about what we know. I think that would be a better answer.

Senator COHEN. Thank you, Mr. Chairman.

Chairman GLENN. Senator Dorgan.

Senator DORGAN. Mr. Chairman, the electronic filing system, likely because it is new and also because it probably creates conditions that are easier to access money from the IRS, would in its early stages show some evidence of increased fraud. The numbers, as I understand it, in the last 4 years are 6,000 returns detected with fraud; 13,000 returns; 26,000; and 43,000. So it is a doubling every year for 4 years.

Again, because it is a new system and because more and more and more returns are being filed electronically, that may simply be a function of what is happening there.

I am concerned, however, about what appears to be an alarming rate of increase in fraud in the paper returns that are filed, and let me just use the numbers that I think the GAO used, and they are probably IRS numbers. There were 12,200 in 1992, 51,800 in 1993—these are paper returns with fraud—and one-third of 1994 is done, and there have been 32,000. That means it would go from 51,800 last year to about 100,000 this year.

Now, that is a very significant increase and one that sets off real alarm bells. We have had a paper filing system for a long time. Would we expect to see substantially increased detection capabilities to boost these numbers, or aren't we likely seeing something that is pretty alarming in terms of an increase in fraud on returns that are filed on paper?

Ms. RICHARDSON. I think any kind of fraud is alarming, but I think what we are really seeing are the results of our stepped-up efforts at detection. And what I think has happened is that, as we have learned more about patterns of fraud through the electronic system, we have been able to take that learning and build in filters and build in fraud detection in the paper process. As a result, we have been able to detect more fraudulent schemes.

I think there is no question that the publicity that has surrounded some of the refund fraud has probably given rise to increased fraud attempts as well. But I think that the efforts to put more energy, more resources into detecting paper refund fraud and the paper process is what has yielded those increased numbers.

Senator DORGAN. But if the bulk of this is simply better detection, that would suggest that last year, 50,000 cases of paper tax returns filed with fraud were not detected versus this year. If you go from 50,000 to 100,000 in 1 year, and if it is simply detection, it suggests that the detection either was so bad, or it is now so good, that there is a difference of 100 percent.

Ms. RICHARDSON. Well, as I said in my prepared statement, fraud is a dynamic process, and as the schemes change and as people become more sophisticated, or as you put in place more filters, I think that, as I said, we have been able to discern patterns in the electronic field, and we have been able to move those into the paper area. There may be some increase in the fraud, but I think we also have better detection.

Most of the experts in the fraud area—and I will let Mr. Brown speak to this—will tell you that because you are not detecting fraud does not mean it does not exist. So there is almost a perverse situation where, the more fraud you detect, sometimes the better off you are in terms of being able to build in filters and that kind of thing.

Senator DORGAN. Yes, but I would just observe that the massive amount of fraud and scandal with respect to Wall Street and junk bonds and S and Ls, and so on—that is not detection; there was a radical change in this country in the way people did things, the way people behaved. I am just wondering whether that same circumstance now spills over into the filing of tax returns, or whether it really is something that you pass off as better detection.

Ms. RICHARDSON. I do not think it is only better detection. I think there probably is some increase in the amount of fraud. I think the real key, though, is to forcefully go after people who are perpetrating these things, particularly those who are doing widespread screens, and make it very clear that we do plan to enforce the law, and we are stepping up adding many more resources next year to our fraud detection efforts and our prosecution efforts. We are serious about controlling fraud and preventing fraud.

Mr. DOLAN. Plus, I think it drives up upstream, like we have talked before, to the extent that we have to match actual information after the fact; we have to actually match income information after the fact, and we do not have a better system for validating dependents at the point of contact.

Those are things that TSM will allow us to do upstream in the future such that we are not having to rely on the detection of a mismatch between stated income and actual income. And I think until we get to that point, again, it is going to be very labor-intensive to rely strictly on the detection.

Senator DORGAN. I respect all of those difficulties because they are the peculiarities of the revenue system where you have to match massive amounts of information over here with the returns filed. I fully understand that. I will just again make the point that we need to try to figure out what is simply detection in terms of these fraud numbers, going from 50,000 to 100,000, and what is the increase in fraud, because if you have a substantial increase in fraud, then it seems to me one behaves differently as an enforcement agency and as a service. If you have substantial increases in fraud, then you begin a substantial program with Justice and with others, a massive information program that says, look, we have got a serious problem here.

And I am just trying to determine with the questions what you view as the problem. Is it merely detection, or is it an increase in fraud, and if so, do you have some notion of quantity, or are you trying to inquire about quantity?

Ms. RICHARDSON. Well, we are definitely inquiring about quantity, and I think all of this comes under Mr. Brown's responsibility, and Ted, you might want to talk about what we are doing now.

Mr. BROWN. Well, Senator, I think the things that we have really come to grips with over the last year to 2 years are, first, the traditional view in the Service was that questionable refunds were a Criminal Investigation functional problem; they will detect it, they will prosecute it, they will deal with it. That is the first thing we realized. When you are talking about 3,000 or 3,500 false claims, that is a workable problem; when the numbers get as large as they are, that no longer works. You cannot prosecute that many people, and you do not want to. So we have really tried to make a multifunctional change, to involve returns processing, to involve the Examination function, to look at Collection, to look at our systems, to bring everybody into the fray, so we do a better job of detection.

At the same time, we are undertaking research-oriented type tests, both by sampling as well as the Los Alamos research, to try to get a better handle on what are the fraudulent returns, what do

they look like, what characteristics do they have, so we can use that to put into improved filters and detection.

The other thing that I think has impacted the numbers over the last 2 years is the resources that have gone directly into our Questionable Refund Detection teams. In 1992, there were about 253 FTEs that were used for those screenings, and in 1994, it is 531. That also has had a substantial impact, because when we get this haystack of suspicious returns and try to find the fraudulent returns in that mass, the more people you have looking through, it even in an inefficient manual process, you are going to find a few more of the needles.

Senator DORGAN. My time is up, but I just want to make this point. I understand this is largely a voluntary system. This Government cannot prosecute 50,000 let alone 100,000 people through the court system, and if it goes from 100,000 to 500,000 and then one million, the system collapses. And in other countries we have systems that are completely collapsed. The voluntary tax system in which you rely on people to voluntarily meet their obligations has collapsed in a number of countries.

So that is why I am trying to understand, when we go from 12,000 to 50,000 to 100,000 in 3 years of paper tax returns filed fraudulently, what we need to understand is whether that is detection or fraud. If that is fraud, that is very, very serious and a very alarming trend, because we cannot possibly catch it and keep up with it, and we cannot prosecute that number.

So I would like to speak with you after the hearing and talk further about this.

Unfortunately, Mr. Chairman, we have had a meeting in the back room, and I regret that I missed some of the testimony, but I appreciate very much the cooperation of the GAO and the Service.

Chairman GLENN. I think the point Senator Dorgan was making in closing there is very good. We do not want to develop a Nation of tax scofflaws; if we ever get to that point, we will never get it reversed. And the TSM system is what you are relying on to do that, and I really—and we made some jokes about this a little while ago—but anything you can do, or any way we can help out to keep that thing on track, because we have a tremendous reliance on that, and it is very, very important. So I think it is important that we get the system in.

Thank you very much. We have gone way over on the time we had alloted this morning. We appreciate your testimony, and we may ask you to respond to written questions, also.

Thank you.

Ms. RICHARDSON. Thank you, Mr. Chairman.

Chairman GLENN. The next panel this morning includes James Thomas, Inspector General at the U.S. Department of Education, and the honorable Madeleine Kunin, Deputy Secretary at the U.S. Department of Education.

Thank you so much. Sorry we went over so long on the first panel this morning, but, Mr. Thomas, if you would lead off for us, we would appreciate it.

TESTIMONY OF JAMES B. THOMAS, JR.,[1] INSPECTOR GENERAL, U.S. DEPARTMENT OF EDUCATION

Mr. THOMAS. Sorry for the delay, Mr. Chairman. I almost got trampled trying to get in.

Mr. Chairman and members of the Committee, thank you for inviting me to share with you the views of the Office of Inspector General on problems associated with fraud and abuse in the Education Department's Federal Family Education Loan program, and the lessons that the FFEL program can teach us about how to implement the new Federal Direct Student Loan program.

As is the case in any transition between systems, the potential exists for problems to occur in the transition to direct lending. In addition to the problems with the FFEL program that will carry over to direct lending, there will be problems associated with winding down the old programs as well as starting up the new.

Based on our audit and investigative experience in the student loan programs over the past few years, we believe the lessons that should be kept in focus by the Department and the Congress as the transition to direct lending proceeds include the gatekeeping functions, failure to pay loan refunds, and lack of assurance that vocational training will help in obtaining gainful employment.

As we have reported on many previous occasions, the gatekeeping process has proven insufficient in keeping weak and unscrupulous schools out of the Title IV programs. While in 1992, the Congress enacted many provisions aimed at correcting gatekeeping deficiencies, and the Department has worked diligently to implement these improvements through regulation, such improvements are yet untested. We are aware of nothing in the design of the direct lending program that will compensate for gatekeeping weaknesses should these improvements prove inadequate.

However, because the Department is being very selective in choosing schools for the initial Direct Loan program participation, gatekeeping weaknesses might not surface until 2 or more years out, when the remaining schools enter the direct lending program.

A second area of concern relates to failure on the part of the institutions participating in the current loan programs to pay loan refunds when students withdraw from school. Students are being victimized by the schools' failure to pay refunds, and when loan defaults result, the taxpayer is victimized as well.

While it is not possible to accurately quantify the magnitude of this problem, it is among the most frequently recognized problems in our review of schools. Several amendments to the Higher Education Act enacted in 1992 will help in addressing the refund problem, but will not solve it.

In my testimony earlier this year, I offered several recommendations for changes in statute to help reduce the refund problem. These include requiring schools to report regularly to the Department the status of their refund liabilities, enacting changes to program fraud provisions to counter a recent court decision that weakens the ability to prosecute refund fraud cases, and enacting legislation facilitating our use of asset forfeiture as a means of recover-

[1] The prepared statement of Mr. Thomas appears on page 83.

ing Federal funds stolen by school owners via their failure to repay loan refunds.

We are aware of nothing presently in the direct lending system that will address the problem of unpaid loan refunds. However, we have been working with the Department to develop methods to identify schools that may not be paying required direct loan refunds.

A third lesson learned from our review of the FFEL program is that the current system of Title IV funding for vocational training affords little assurance that the training provided to students is helping them obtain gainful employment.

We have recommended that the labor market needs and the performance of schools in graduating and placing their students be considered in SFA funding for vocational training. The OIG and the GAO recently completed a joint audit of the FFEL program's fiscal year 1993 financial statements. The audit report concludes that we could not express an opinion on three of the four financial statements because reliable student loan data was not available to reasonably estimate the program's liabilities for loan guarantees and other related line items.

We were able to express an opinion on the statement of cash flow. Due to internal control weaknesses, we could not determine if the Department of Education received or disbursed proper amounts to lenders and guaranty agencies.

The Department's internal controls were not properly designed and implemented to effectively safeguard assets and ensure that there were no material misstatements in the principal statements.

The Department reported liabilities for loan guarantees as of September 30, 1993 as $13.6 billion. This amount is the Department's estimate of the net present value of cash flows that are likely to be paid by the FFEl program on loan guarantees outstanding as of September 30, 1993. There is no way of knowing at this time the potential misstatement of this liability.

We believe that what happens in the future relative to guaranty agencies will affect potential liabilities because guaranty agencies have had a significant role in the administration and oversight of the FFEL program.

During the phase-in of the Direct Loan program, the stability of these agencies will be significantly affected. As guaranty agencies and lenders leave the program precipitously, proper servicing and recordkeeping for the loans they have made and guaranteed may be jeopardized; and student access to FFEL loans may suddenly be severely restricted.

Although the statute has provided a Lender of Last Resort program to address the potential student access problem, the effectiveness of the provision is yet to be tested. Also, the Department's ability to maintain uninterrupted servicing of billions of dollars of FFEL loans will be tested when guaranty agencies, lenders and servicers leave the FFEL program.

The Department of Education faces many challenges in its efforts to reduce FFEL losses and addresses longstanding financial management problems, the most important of which is correcting the numerous data integrity problems.

A number of corrective actions are underway, including the development of the National Student Loan Data System, the first national database of loan-by-loan information. That database will be available for use in prescreening loans for queries and analysis by the Department, monitoring borrowers in schools and for tracking loan portfolios.

Currently, guaranty agencies are the primary source of the NSLDS data. With the advent of the Direct Loan program, they may have no incentive to institute new or revise old systems together and control the data needed for this new data system.

Currently, there are no realistic penalties that can be assessed for providing incomplete or inaccurate data. For this reason, the Department has reduced the data accuracy and completeness requirements and will not require clean-up of all historical data.

In the OIG planning process, we have identified several factors that represent potential risk regarding guaranty agencies during the transition to direct lending. We anticipate using these factors to develop a matrix or profile that can be used to track changes and the impact of these changes on guaranty agencies. We hope that continuous coordination with program officials in the Department and site visits to guaranty agencies will help ensure that appropriate adjustments are made, that the Department has the most current and accurate data available, and that mechanisms are established to provide the Department early warning of emerging problems.

Finally, you have asked me to discuss the difficulties, including the potential internal control weaknesses associated with starting up the Federal Direct Student Loan program. If a typical time frame for the development of a system is about 2 years, then it can be said that the direct loan system was developed in one-fourth of what would be the normal time. Unfortunately, given the time frame of this system design, full testing of the direct loan program could not be accomplished prior to operation on June 15. Thus, the real stress test of the system is only now taking place during operation, while 104 schools are participating in providing almost $1 billion worth of loans under the system.

Any software deficiencies will appear in operation, and stabilization of the operational environment will of necessity take place during that time. We participated sa advisers in the direct loan system's development, and we are aware of the time constraints. We were told that many changes would necessarily be deferred to the second year. We are chiefly concerned that the Department may be faced with the monumental task of addressing system errors while at the same time expanding from 5 percent of loan volume in 1994–95 to the required 40 percent in 1995–96, which represents a 700 percent increase in volume.

Because the direct loan system just became operational on June the 15th, and the first loans were made on July the 1st, it is not practical at this time to discuss specific control weaknesses.

I would also like to mention several statutory issues. Under the 1992 Amendments of the Higher Education Act, effective July 1, 1993, PLUS, the Parent Loan program, loan limits were repealed. Lenders in the FFEL PLUS program, using accepted banking pro-

cedures, may require a determination of the borrower's ability to repay a PLUS loan.

In the Federal Direct PLUS Loan program, the statute provides that the servicer will examine only the credit history of a borrower. While credit history may indicate a willingness to repay, it does not necessarily show that the borrower can assume additional debt. Without determining debt-to-income, the Department may be making substantial PLUS loans to parents who are willing but unable to repay them.

Another statutory issue that poses a potential problem is the unsubsidized loan program that was authorized under the Student Loan Reform Act of 1993. This program will extend loan availability to a large number of students who do not qualify for the subsidized loans.

The effect of more available Federal money may be tuition increases, which could cause more borrowing on the part of students and parents; and repayment of these loans may cripple borrowers for years to come.

Mr. Chairman, much of what the Department has accomplished in planning for and managing this transition to direct loans is cause for optimism, while many aspects of this change remain of concern.

I look forward to working closely with the Department and the Congress to accomplish this most efficient and effective transition between these two programs.

Mr. Chairman, this concludes my summary statement, and I will be happy to deal with questions as you see fit.

Chairman GLENN. Thank you, and your longer statement will be included in the record in its entirety.

Secretary Kunin, we are glad to have you with us this morning.

TESTIMONY OF MADELEINE KUNIN,[1] DEPUTY SECRETARY, U.S. DEPARTMENT OF EDUCATION

Ms. KUNIN. Thank you, Mr. Chairman. I very much welcome this opportunity to appear before your Committee today on the critical subject of reducing fraud and abuse in the Federal Government. If we share a common purpose at this hearing, it is to change the future title of this hearing from "High Risks and Emerging Fraud: IRS, Student Loans and HUD," to "How Three Federal Agencies Reduced Risks and Eliminated Fraud."

No doubt your Committee and my colleagues join me in this objective. This is the highest goal of the Clinton administration—to restore the confidence of our citizens in our Government. That confidence rests, of course, as we all know, more than on rhetoric. It will only be affirmed by our actions, which prove to the taxpayers and the students and their families and the institutions of higher learning that every, single taxpayer dollar is well-spent. We cannot afford to waste a cent on fraud, abuse, confusion or error.

Let me say at the outset that we can be very proud of the broad access to higher education that our student loan and grant programs have provided. Thanks to congressional leadership over the years, almost 200 million awards have been made, totalling $300

[1] The prepared statement of Ms. Kunin appears on page 90.

billion made available to students since the inception of this program. Just this year alone, we have seen a 35 percent increase in loan volume, amounting to approximately $24 billion.

More than half of the students, in fact, and families in this country utilize both subsidized and unsubsidized loans. It is safe to conclude from that information that without this program, access to higher education, and thereby a higher income and a better life, as envisioned by the American dream, would be out of reach for millions of Americans.

Our shared purpose here today is, then, not to weaken the system we have created, but to strengthen it through the 2-pronged strategy of expanding opportunity while simultaneously increasing responsibility.

Many Americans dream of furthering their education, but are now halted in that dream because of the barrier of affordability. The new Clinton initiatives of direct lending and income-contingent repayment, as well as the National service plan, do much to lower those kinds of barriers.

At the same time, we must make our expectations of repayment absolutely clear. Again, the Clinton initiatives have launched a new era of accountability and responsibility.

But in my eagerness to tell you about our preliminary substantial success of our new programs and the strong management ethic at the Department of Education, I do not want to gloss over the depth of our problems.

As Mr. Thomas, the Inspector General, has just elaborated, to totally fix these problems, which have suffered from managerial neglect for many years, will take time. And only constant vigilance and attention to every detail over a period of several years will enable us to completely turn around these programs.

But I am very proud and pleased, as is Secretary Riley, that we have made a very substantial start. For the first time overall, the Department has a strategic plan, a strategic plan that is tied to the budget; and with that come many other managerial structures that have been put in place for the first time.

Just to give you an indication of some of the progress that has been made which is attributable to the new legislative tools as well as the greater management incentives, we have, for example, reduced the costs to the Federal Government from $3.6 billion in 1991 to an estimated $2.3 billion in fiscal year 1994. We also have had considerable success in increasing our collections of bad debts from $4.4 billion in 1991 to $6.4 billion in 1993, which is a 47 percent increase. And that is what is important for you to know today, that we are making these improvements; we are on track; and the turnaround is taking place. Most importantly, we have made the investments in people, in technology, in training, and in management.

Let me also take this opportunity to introduce to you the two people who are here with me at the table. And when I say "investments in people," I think they exemplify our very best investments in that regard.

To my right is Leo Kornfeld, who is the Deputy Assistant Secretary for Student Financial Assistance. He was with the Department in the earlier administration, in the Carter years; he has

been in the private sector, and is very knowledgeable about technology and the world of finance. We are very fortunate to have him in this role.

Next to him is Don Wirtz, who is our Chief Financial Officer and, not coincidentally, was the chief person at the GAO who developed the high-risk reports. So we have a person on the inside who has been our chief critic from the outside and is the best-equipped person to help us fix these problems. And it is their leadership and their attention to detail, as well as Secretary Riley's and, of course, Assistant Secretary David Longeneker, that gives us great confidence that we can deal with these tough questions and continue to make substantial progress.

We have some tools that we did not have before. One is direct lending; another is more gatekeeping strategies; the third is that students will now be offered repayment options. And a fourth point that was not included in my written testimony but is worth mentioning at this point is that we are providing students for the first time with real counseling before they take out a loan, so that their responsibilities are absolutely clear to them as well as the responsibilities of the institution.

Let me just dwell briefly on these points without going into the full details, and any further technical questions I know my colleagues would be pleased to address.

First, the direct lending program is a new program. We have started out with the first 5 percent of the loan volume as the Congress determined we should do, as we gradually move from 5 percent to 40 percent to 50 percent, or as much sa we can attract to the program.

The good news is that, as was just stated, this program was asked to come on-line in record time; one-quarter of the time that is usually alloted for programs of this magnitude. One recent review I would like to enter into the record is an unusual story for the Department of Education, and that is: "Front-line Staff Praises Direct Student Loan Launch," is the headline in Education Daily. I will just read you two sentences: "When Congress authorized the Direct Student Loan program last year, skeptics doubted the Education Department could meet its tight, 11-month start-up deadline. Yet, Ed not only met Friday's target, but it did it so efficiently that school officials were singing the praises of a Department that is much more used to explaining its problems."

And while the jury, of course, is still out for the long term on how this program will be effectively managed, I think we are off to a most impressive start. And I am pleased to say that the staff and everyone else really worked very cooperatively to meet every, single deadline that has been expected of us.

I think it is an indicator of the new climate within the Department of Education of the new focus on management, on customer service, and on making sure that whatever program we run is done to the highest management standards.

And frankly, as we looked at the existing student loan program when Secretary Riley and I and the others first arrived on the scene, and we read the earlier GAO reports, it became absolutely clear that under the existing system, if there were no changes made, we could never come back to this Committee or any other

Committee and say this system is under control, because the complexity of the system, the lack of accountability, the 8,000 lenders just create a Rube Goldberg type of chart that can never be straightened out to the taxpayers and to our satisfaction.

So now we do have a chance to have a more simplified system, with fewer players, greater accountability and, as you know, substantial cost savings of $4.3 billion over the next 5 years. But it will also do what this administration places great priority on, and that is to be able to provide better customer service, and our customers are the students, their families, and the institutions of higher learning.

In addition, we found preliminarily that the schools are very pleased with this program. It is more simple for them; we are providing them software, we are providing them training, and we are giving them an opportunity to improve their financial management systems as we provide them the opportunity to participate in direct lending if they are ready to do so.

Of course, another aspect of this is gatekeeping; and while there is still more to do, and while the information we have from guaranty agencies and others does not meet the ultimate standards we would like to have in terms of accuracy and reliability, we are doing some things that have never been done before. We are being much tougher on who we let into the program, and having a more clear review process as well—a review process that pinpoints the high-risk institutions at a much earlier point.

We are also training our reviewers so that they are better equipped with both computer technology, so that they know what to look for—just as Willie Sutton is, we asked them to look for the money is—and focus on what counts, so that we can have a better accountability at the very inception. The best way to prevent fraud and abuse is to keep out those institutions that make it perfectly clear they are not capable of handling these finances.

We increased the number of reviews from 117 to 172 just recently and project that we will continue to escalate that kind of review process.

We are also, through direct lending, learning a great deal about how to be tougher on abuse, early. For example, it takes about 18 months to even find out what is going on in an institution under the present system. Under direct lending, there will be monthly reconciliations, so the red light will go on on a monthly basis if there is trouble, allowing us to zero in as quickly as possible.

There are other details that one could spell out as to how this program is working. I guess in summary what I would share with you is that we are optimistic; we are confident, based on our experience thus far, that direct lending will give us an opportunity to improve not only the programs that are in the direct lending area, but also the enter guaranteed student loan system, because we are learning a great deal from the mistakes of the past and here today as to how we run the programs in 1994.

We are also pleased that we have the tools, in terms of staff, in terms of funding, in terms of technology, software, and hardware, to make this program work.

We are also aware that we are going to learn along the way. We are making a big change from 104 institutions, as we move from

5 percent to 40 percent, which will involve some 1,800 institutions, and we are going to monitor that very, very closely along the way. But with proper training and with eternal vigilance, we are confident that the taxpayers can be assured their money is well-spent, that students will have an opportunity to have access to higher education, and that the higher education community will also be responsible in this partnership.

Thank you very much.

Chairman GLENN. Thank you very much.

I want to commend all of you for your work in education. As you indicate, it has really been a hallmark of this country in helping our young people, everyone, whatever their economic background, to have a shot at a higher education.

You indicated, I think, that some $300 billion had been spent in this area. Was that the figure?

Ms. KUNIN. Yes.

Chairman GLENN. Do we have any comparable figure as to what has been in default as a percent of that $300 billion? I had never heard that total figure of $300 billion before, and I wondered if there was a comparable default figure.

Ms. KUNIN. The default rate is about 17 percent; cumulative default is 10 percent over that period.

Mr. KORNFELD. If you calculate as a lender would, cumulative default in the program is about 10 percent.

Chairman GLENN. Overall, for the whole $300 billion.

Mr. KORNFELD. The total program, the life of the program.

Chairman GLENN. OK. You have an enormous task ahead of you. You are going to be increasing the direct loan program by 700 percent, approximately, over the next year. And maintaining tight control over that, when we had so many problems with the old program, is going to challenge everybody. Now, obviously, you are going to do the best job possible; are you having to cut people at the same time? Are you part of the 252,000 cut program across Government? If so, what whack are you taking, and how are you going to do this? Cutting people, winding down an old program with all of its problems, and one that we had problems managing through the years, and putting a new program on is an enormous job. And are you cutting people at the same time?

Ms. KUNIN. No, we are not. The full postsecondary education area is not part of an overall cut in FTEs. In fact, we are seeing an increase from I believe it is 1,398 to 304 in 1995. And we are doing that by reaching the overall administration goal of cuts in FTEs in 5 or 6 years, but shifting things within the Department.

But we share your concern precisely, that you cannot gear up for a major new program and cut people. So we are growing in that area, but we are also investing very heavily in training so that our existing staff have the tools that are necessary to do the job. Also, the buyout has in fact given us an opportunity. Some 70 people took advantage of the buyout in that area, and this gives us an opportunity to hire people with strong financial and management skills.

So that the combination of new technology, training, and very selective hiring of highly-skilled people enables us to make this transition. And let me just add another note, Senator, and that is that

this program is easier to manage than the existing family student loan program, because it is less complicated. There is only one form a student fills out; there is one source of information, and that is the Department; there is a contractor. You know where your loan is, you know who is responsible, and there is much more regular monitoring of the system.

So that while it is a daunting task, there is no question about that, we feel that it is very feasible to gear up to it in a reasonable way.

Chairman GLENN. Are we making any effort to direct people into certain jobs? One of the criticisms of some of our past guaranteed loan programs has been that we spent millions to train students for nonexistent jobs. I do not know if there is any way to control that. I saw a figure not too long ago, as an example, that you do not need the same academic background for training to be a cosmetologist. And every young lady grows up with a big interest in makeup and cosmetology and hair care and so on, and so we apparently had enough cosmetologists trained to put makeup on North and South America almost every morning—in other words, the point is we were training people for jobs that did not exist.

Do we try to alter that by counseling—you cannot tell people, no, you are forbidden from taking on the training that you might have thought about since your earliest years—how do we control that, or is there any control?

Ms. KUNIN. The best strategy that we believe will work is to provide consumers information about how many people got jobs from that program; how many people graduated. And the new State Program Review Entities, called SPREs for short, we are working with them to put that into the standards that they are creating in their review process.

When people apply to Harvard, they usually know a great deal about what happens to the graduates of Harvard. When they apply to beauty school or truck-driving school, they may not know what happens to the graduates of those institutions.

Chairman GLENN. Yes, but are we going to be able to control these little, fly-by-night schools that jumped up just to bilk people out of money, and they did not have any accreditation and would give some fake diploma. We had so many cases of that that occurred in past programs. Is there any way to control that under the new program?

Ms. KUNIN. Well, the best control will be by keeping those kinds of schools out of the whole student loan program.

Chairman GLENN. Do we run an assessment of each school?

Ms. KUNIN. That is correct.

Leo, you may want to elaborate on that.

Mr. KORNFELD. If it is a new school, or if there is a change of ownership in a school, in order to be accepted into the Title IV programs, student financial aid programs, in addition to being licensed and accredited, they have to submit financial statements, they have to indicate to us both administrative and financial capabilities, and in the last year alone, we denied one-third of those schools into the program because they did not demonstrate administrative and financial capabilities.

Chairman GLENN. Are we going to have performance measures, Mr. Thomas? What kinds of performance measures are you going to set up? Are those in place now, or are they still being developed?

Mr. THOMAS. Senator, we have been working with the Department and with the contractors at the Department to try to set up some indicators of failure to meet certain levels of performance, certain things that we could track, such as what the Governor mentioned earlier about reconciling the cash balances on a periodic basis. What we will do is track those where they could not reconcile them and see, from period to period, whether those numbers have gone up.

We will also try to track complaints by institutions to see whether complaints are increasing, staying the same, or going down.

So there are some mechanisms that the Department is building in, and we are just providing them advice in that area. We are not setting up at this time any separate set of performance measures for the program.

Chairman GLENN. OK, but you have got a dual function there. You have got to wind down the old system and have some sort of measurement as to whether we are winding it down properly while you put a whole new one in. That is a big job.

Mr. THOMAS. it is a big job and a big challenge, Senator, particularly the old one, and this is going to be a real challenge for Leo and his colleagues in keeping track of the lenders and the guaranty agencies as they begin to wind down and go out of business.

I think one of the major problems that the Department has today and has had in the past is that of inadequate data. Most of the data the Department gets from the guaranty agencies is not accurate and not timely. You heard the Governor mention waiting 18 months to find out anything, whereas the new program will be an on-line system where we will know, every certain period of time, maybe weekly or maybe monthly, the different data.

Even though some of the data that will still be coming in from the guaranty agencies will not be 100 percent accurate, at least we will know about it in a timely manner and will be able to take certain preparatory steps relative to it. I think that is a step forward.

Chairman GLENN. Senator Cohen.

Mr. WIRTZ. Mr. Chairman, if I may add to that.

Chairman GLENN. Sure.

Mr. WIRTZ. The student loan program is a pilot program with respect to GPRA, so we are working with OMB right now in developing performance measures for the whole program and really trying to get to outcomes as well as just inputs. So it is something that we are very concerned about right now.

Chairman GLENN. Thank you.

Ms. KUNIN. I would just add a note about the transition. When the legislation was designed, that was a very important part of the debate, that we did not want to have any student be caught between the cracks and to assure the adequate cash flow to continue to make student loans.

So there is a provision for Lender of Last Resort, and thus far, two guaranty agencies have left the program and two are considering it; but so far, we have not had a major problem. But we are

very alert to that possibility and are ready to spring into action if it should occur.

Chairman GLENN. Good.

Senator Cohen.

Senator COHEN. Thank you, Mr. Chairman.

I am a little confused by your testimony, Governor Kunin, because you gave a very celebrated defense of the virtues of direct lending. I believe, Mr. Thomas, when you testified before the House Appropriations Subcommittee on Labor, Health and Human Services, and Education, you expressed your concern that the problem of unpaid refunds would only get worse with direct lending. I am confused.

Mr. THOMAS. The getting worse was not in the direct lending program, Senator, and I explained that in the testimony. The getting worse because in the process of moving from the FFEL program to the direct lending program, the Department is having to devote, in my opinion, more and more of its resources to the new program.

When I see the old program winding down and the guaranty agencies going more and more out of business, then I see less and less attention being paid to administering the Department's programs. As a consequence, I think that over this period of phase-out, there will be a very good likelihood that the default problem will in fact increase.

Senator COHEN. So the problem lies with the phasing out of the old program, with more and more resources, personnel and attention being paid to the new direct lending program?

Mr. THOMAS. That is my opinion, yes, sir.

Senator COHEN. Are we moving too quickly to implement the new program without paying enough attention to the old one?

Mr. THOMAS. Well, in my discussions with Leo and David Longanecker, the Assistant Secretary, it is my opinion that they are trying to get the balance, and they are required by law to move into the new program, the 5 percent the first year and the 40 percent the second year.

Just incidentally, that 5 percent the first year would make them the second-largest lender in the country, moving from zero to right behind Citibank in the volume of lending. In the second year, it would make them equivalent to just about the 25 largest lenders in the United States combined together. So it is a major task, and there is a lot of effort and a lot of attention going into that.

So that is how I see where the priorities have to be right now.

Mr. KORNFELD. Senator, I would just like to add that we have added 60 more program reviewers, and part of our program review process as we visit institutions is to look at the entire way that the refund aspect is being handled. And in addition to that, if there are any schools at risk where we are concerned about their financial capability, we now require surety bonds and letters of credit and things of that sort, so that if the school does close, there are funds available for refund purposes.

Senator COHEN. Back in 1990, the Permanent Subcommittee on Investigations conducted an inquiry into the abuse in the student loan program, and what we found at that time was that GAO reported that proprietary students accounted for a disproportionately

high percentage of the defaults. So we passed the Higher Education Amendments of 1992, which were designed to increase the accountability of the proprietary schools. We insisted on at least a 15 percent source of revenue outside of the Federal Government for those proprietary schools.

These regulations were scheduled to take effect on July 1, 1994. The House-passed appropriations bill for the U.S. Department of Education would extend that time period, I believe, to July of 1995. Is that something that you support, Mr. Thomas? Is that a good thing to do?

Mr. THOMAS. I do not support the extension, Senator, and I have written a memo to the chairman, telling him that I in fact do not support such an extension. I think that the idea was a great one when it was enacted, and I think it is a great one to go forward with.

There is a myth that the private sector is at work, and that the market economy is in effect at the proprietary schools, when in fact the entire source of revenue is the Federal Government, and there is very little opportunity for the marketplace. If in fact students are willing to pay 15 percent of the total amount of the tuition that is received in that institution, there would be a better indication that perhaps the marketplace is in effect and maybe the tuitions that are charged in many of these schools are in fact justified.

I think that is even more of a problem today than it was when you enacted that law, because of the unlimited amount of the unsubsidized loans that can be added to that amount nowadays.

Senator COHEN. What counts in the calculation of non-Federal financial assistance, in that 15 percent? Would it be the school's own scholarship money; would it be money given to a college by private organizations?

Mr. THOMAS. I am sorry, I do not know the answer to that, Senator?

Ms. KUNIN. Do you have the answer to that, Leo?

Mr. KORNFELD. The 15 percent is supposed to be other income that the institution obtains. For example, in the cosmetology industry, those schools provide services—for example, they do haircuts and things of that sort, and they obtain income. They can include that as income, and that gets included in the calculation.

Senator COHEN. But do you have any kind of regulatory scheme that they can turn to for what constitutes that 15 percent, or is it just something that they have to show that they get 15 percent income outside of the Federal contribution?

Mr. KORNFELD. It has to be programs that are consistent with the programs they are providing, and that they are providing these to persons who are not getting Title IV assistance for that type of education. That is what is included in the regulation.

Senator COHEN. Governor Kunin, I have been contacted by a number of college and university presidents in the State of Maine about the State Postsecondary Review Program regulations which implement the Higher Education Amendments of 1992, and the complaint is that there has been undue expensive burden placed on those fine institutions unnecessarily.

Now, apparently, the Department has moved to clarify the regulations so that postsecondary institutions that are not referred for

review by the State do not have to keep records relating to compliance. Do you intend to clarify the regulations even further, because the complaints are still coming in.

Ms. KUNIN. Well, this has been an area of controversy to some extent, and you are not alone in getting those kinds of letters. But I think it is also an adjustment to a new era. I mean, that was what the Congress asked the Department of Education to do in the 1992 Amendments to the Higher Education Act.

I think what we are looking for is that fine line between more accountability, without imposing an undue burden on the institutions of higher learning, and we have had some very productive negotiations. We have modified the regulations in response to the concerns that have been raised, and I think we are very close to general overall agreement. Some of it undoubtedly will continue to have to be fine-tuned, but we are very open to these suggestions; we want to work as productively with the higher education community as possible.

What is tough in this area, as you so well know, is the overwhelming number of institutions are totally honest, provide an excellent education, and there are some that do not, and they are all being guided by the same law.

Senator COHEN. In your prepared statement, you indicate that some borrowers have defaulted on their loans or have reached their maximum award levels, and yet they are still receiving additional Federal loans. How serious is the problem?

Ms. KUNIN. Well, that is a problem, but our strategy for addressing that in a much more comprehensive way is the National Student Loan Data System, which will begin to be operative, but not fully operative, this September. And the anticipation is that we should save some $300 million of loans that should not be made to students who are already in debt. We are trying to do that in other ways now, but that is the most comprehensive way that we could do it.

Senator COHEN. Thank you very much.

That is all I have, Mr. Chairman.

Chairman GLENN. Thank you, Senator Cohen.

Will that national Student Loan Data System contain all of the Department of Education's financial aid programs?

Ms. KUNIN. Yes, I believe so.

Chairman GLENN. So the old programs, the new programs, everything will come under that; is that right?

Mr. KORNFELD. Yes, Mr. Chairman. The first phase will include the loan data, and then the plan is to have three phases, and eventually, it will include all student financial assistance, be it the loan program, the grant programs; and hopefully, as students apply for loans or grants, it will be matched against the data to ensure that those persons who are ineligible for loans or ineligible for grants, or as in previous hearings, multiple grants and things of that sort, we would have that in that database.

Chairman GLENN. This is something we should have had years ago, isn't it?

Mr. KORNFELD. Yes, sir.

Chairman GLENN. How did we ever operate without something like that; we did not know what we were doing.

Mr. KORNFELD. That is correct, I am sorry to say.

Mr. THOMAS. Mr. Chairman, we recognized that back in the late 1980's with an audit report and a recommendation for the Student Loan Database, and the Congress——

Chairman GLENN. Your reports have been critical of not having it.

Mr. THOMAS [continuing]. Yes, sir, and we recommended it, and the Congress in fact enacted a law and said there should have been one. My recollection is that that was the 1988–89 time frame. But the problem at that time was that the Congress put a little provision in there that said the Department should create such a system, but could not make it mandatory for use by the guaranty agencies. So during that period of time, from then until I believe it was 1992—it could have been 1991—the Department was reluctant to invest a major amount of money into this system when in fact it could not enforce its use.

Chairman GLENN. I do not blame you. Why did we do that?

Mr. THOMAS. I am not sure, Mr. Chairman.

Chairman GLENN. It does not make much sense.

Mr. WIRTZ. There are certain pressures that have been exerted.

Mr. THOMAS. And so it was only when the Congress took that provision out—and I believe it was in 1992; it could have been 1991—that we began implementing the system.

Chairman GLENN. Mr. Thomas, also, according to your testimony, you felt the Department did not do a very good job of screening schools that were allowed to participate in the old program; we had a lot of people who should not have been in that program. How are we going to carry out this screening procedure from now until next year, going from 100 schools to 3,000? Do you think that is possible?

Mr. THOMAS. First, Mr. Chairman, most of that increase in schools is schools that are already in the system, and so there has been some screening already. The new screening process that Leo alluded to I believe only includes those schools that are coming into the system new.

Chairman GLENN. So it is not 3,000 brand new screenings that have to be done.

Mr. THOMAS. That is my understanding, sir.

Ms. KUNIN. I would just add that I believe the anticipated number is 1,800, which is still a substantial increase from 104. But also, we will have certain options. For example, those schools that do not have as strong a financial record will have what we call an "alternative originator," which will be a professional contracting firm that will do the work. And we can also put schools on a reimbursement plan instead of simply giving the money in advance. So that we are creating several screens, hopefully, to avoid the kind of hemorrhaging that has occurred in the past.

Chairman GLENN. Mr. Thomas, your office worked jointly with GAO to audit the Federal Family Education Loan program for 1993. It resulted in a disclaimer of opinion on the program's balance sheet and highlighted a number of problems.

I understand GAO will not be so involved in the 1994 financial audit. What are your plans for doing that, and is the CFO going to be involved with that, or how are we going to do that?

Mr. THOMAS. That takes me back, Mr. Chairman, to the question you asked the Governor earlier about whether the staffing in the Department had been decreased, and the Governor, I think very appropriately, said no, it had not been for the student aid folks.

In the IG's office, however, there has been a slight decrease; but more important than the slight decrease is the increase in the number of activities that the Congress has passed in the last 3 years and has not provided funding for—for example, the direct loan program, the CFO Act, and several others. And as a consequence, the time that my staff has previously had the opportunity to spend with these unscrupulous schools that you very appropriately alluded to earlier in the future will be directed toward doing financial audits of the CFO Act.

Now, you appropriately said that this year, we did this joint audit with GAO on the 1993 financial statements. Next year, the GAO is moving out of that, and we will take that over with our staff. The only way we are able to do that is that, in my discussions with the Department, they were able to come up with some contract money where we are going to contract with a CPA firm to do the financial statement audits of the direct loan program.

Now, there is no money in my budget either for the present year or in 1995, that is, working on the Hill today, to allow that to happen for next year's financial statement. So each year, we either are right at the brink of do we do these audits required by law; are we able to get money from someplace else in the Department. And I am told that each year, their ability is tighter and tighter with these funds.

So this year, I think we are OK, for the 1994 statements. Next year, I may not be able to do them. I just do not know the answer to that yet, and it is a tough call that will have to be made at that time.

Now, if we run into difficulty with staffing for the 1994 statements, I believe I can get GAO to come in and provide us with some support to get over the hump. I think they left the door open; they are not completely out. They want to be out, but they are willing to help.

Chairman GLENN. Meanwhile, I am sure Secretary Kunin is going to be working with you to try to get you some money—I hope.

Ms. KUNIN. Absolutely. We are also changing the auditing process to make it more effective. So it is not just a question of volume, but results.

Mr. WIRTZ. Maybe I could add to Jim's statement. As Jim said, the Secretary and Deputy Secretary are strongly supportive of moving forward with audits of the Department, and we felt it so important that we had to come up with the funds necessary to be able to audit the direct loan program this first year. We think that is terribly important to say how is it doing, and how can we improve.

We also believe that the audits themselves have been a driving factor in the improvement of our ability to manage the program as we have moved forward. We continue to believe that, and because of that, we are planning right now for our 1996 budget to be able to provide funds to contract for an audit of the Department as a whole. We want the Department to have audited financial state-

ments, and that will include both the direct loan program and the guarantee program.

Chairman GLENN. Thank you. The CFO Act was my legislation that we put in through this Committee, and it passed; and it is almost unbelievable that we have operated for a couple of centuries without having a requirement for agencies and departments of Government to have a bottom line audit at the end of every year, just like any business, to see where the money went, what was spent well, what was not spent well, how can we do better next year. We did not have that, and we are just now getting that instituted in our third year of CFO this year.

Charles Bowsher, the Comptroller, said he felt it was the best step forward in financial management in the Federal Government in the last 40 years, to use his words on it. We have that; we have the IG Act that this Committee put through and expanded a few years back, after having experimented with the 12 agencies it was in over the first 10 years of the IG Act. We have expanded that now, and I think we have the tools to really manage things properly inside each agency. And of course, the CFOs and IGs also have to report to the appropriate oversight committees of the Congress. So I think we have all the tools now to really do a good job in this area.

We look forward to working with you in these areas as you go along, particularly as you try to institute this new loan program. That is going to be a big one. If you need legislative help on something from here—we do not want to come back a year from now and say this one is as fouled up as the old one used to be—if there is something we can do to help out, we want to do it now, not wait until after the wreck. So keep us advised.

Thank you all very much.

Ms. KUNIN. Thank you very much, Mr. Chairman.

Mr. THOMAS. Thank you, Mr. Chairman.

Chairman GLENN. Our next and final panel this morning has been patiently waiting—or, I hope patiently, anyway. We welcome Susan Gaffney, Inspector General at the U.S. Department of Housing and Urban Development; and Nicolas B. Retsinas, Assistant Secretary for Housing at HUD.

Ms. Gaffney, I am sorry we are so late this morning, but we have had a lot of very interesting testimony this morning. We look forward to your testimony, and if you would please lead off, we would appreciate it.

TESTIMONY OF HON. SUSAN GAFFNEY,[1] INSPECTOR GENERAL, U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, ACCOMPANIED BY CHRIS GREER, ASSISTANT INSPECTOR GENERAL FOR AUDIT, HUD

Ms. GAFFNEY. Thank you, Senator. Accompanying me today is Chris Greer, the Assistant Inspector General for Audit.

I have been the IG at HUD for just about a year; Chris has been there for 20 years. So if you want to know where the expertise is——

Chairman GLENN. Institutional memory.

[1] The prepared statement of Ms. Gaffney appears on page 94.

Ms. GAFFNEY. Right.

I would like to say something at the outset about financial fraud in HUD. What is different about HUD and financial fraud is that you see it very dramatically and graphically. It is not just some amorphous concept of lost taxpayer dollars. It translates into deteriorating buildings; it translates into horrible living conditions for poor people. And one of the things I would like to recommend to you if you have not seen it is the cable television investigative report that is titled, "HUD: America's Slumlord." I think you will find it a very compelling illustration of why financial fraud in HUD is so important.

Chairman GLENN. What is the title of that, again?

Ms. GAFFNEY. "HUD: America's Slumlord." We can get you a copy of the tape.

Chairman GLENN. I would like to have it; thank you. Was that PBS?

Ms. GAFFNEY. It was cable, the A & E Network.

Chairman GLENN. OK. Good.

Ms. GAFFNEY. To move on, before talking about equity skimming in HUD's multifamily insurance program, I would like to characterize the multifamily insurance program. It was designed to be high-risk, and it is high-risk. Obviously, it is attempting to provide housing that the market is not otherwise providing; that is its niche.

However, its high-risk nature is clear for the following reasons. First of all, typically, the borrower is a single-purpose entity, organized solely for the purpose of owning this project. The insured mortgage is non-recourse debt, which means the individuals involved cannot be held accountable. Often, only a minimal down payment equity investment is required—along the lines of 10 percent—and usually, this equity investment is made up of non-cash items, such as fees earned during construction of the project.

Obviously, the lender's position is protected by the FHA insurance. And the final ingredient in this high-risk situation is that clearly, FHA lacks the systems and the staffing resources it needs to oversee these projects.

Now, we are talking about insurance in force now of almost $44 billion, and there is no doubt that Mr. Retsinas can do something to fix the systems problems. It appears not to be within his ability to staff these programs in the way they should be for the purposes of prudent oversight.

If we take this high-risk program, it is clear that the high risks have had consequences. As of the end of September, our audit of the FHA financial statements showed that FHA held $8 billion in loans, for which insurance claims had already been paid. FHA had $43.9 billion of insurance in force. Price Waterhouse put the loss reserves for that portfolio at $10.5 billion. In fiscal 1993, FHA paid almost $1 billion in insurance claims.

So not only is this a high-risk program, but the risks are having clear consequences. The question is what role does equity skimming have to play in these consequences.

First of all, equity skimming is defined by criminal statute, and the criminal definition is essentially this is the expenditure of

project funds for other than necessary project costs, in cases where the project is either in default or a non-cash surplus position.

The question before us is what role does equity skimming—and let me just pause and say that for purposes of civil action or administrative action, we talk about equity skimming in a broader sense, and that is this is taking project revenues, income, and using them for noneligible, inappropriate costs. And at its extreme, you have the owner of one of these projects diverting rental income and using it to buy yachts, that kind of an extreme case.

What we know about equity skimming is that—what the OIG knows—is that it tends to occur when projects get in trouble. We have identified just recently 117 cases of what we think is equity skimming, and we think the equity skimming attached to those 117 cases is in the neighborhood of $92 million. This is very rough. I am trying to define for you what the potential universe of equity skimming is. If we were to take those 117 cases and their implications of $92 million in equity skimming, almost $1 million-to-one ratio, and if we were to apply that ratio and assume $1 million in equity skimming for every really troubled FHA project, you would be in the neighborhood of $6 billion of equity skimming. And I have no way of knowing whether that is an accurate projection. It is entirely ball park.

The problem that we have in this area is that we do not know what the universe is; we do not know how bad the problem is. And the reason goes back to what I talked about before—our systems are poor, our oversight is poor, and we have done very little in HUD over the years in terms of taking action against owners for equity skimming.

There are a couple of reasons. Staffing is one. There is a culture in HUD traditionally that has focused on production versus enforcement. To the extent that there has been enforcement, it has been seen as the IG's problem, not the HUD program staff's problem.

There is also a problem in terms of the tools available to HUD to stop equity skimming. There are problems. If you declare a default of an insured mortgage, it leads to a claim on the FHA insurance fund. The people who control the Federal budget do not particularly appreciate that.

If you default on a Section 8 contract that is associated with the insured mortgage, that means that those tenants no longer can afford to live in that housing; and what do you then do with them?

If you try to abate the Section 8 payments, the owner is not getting the income he needs, theoretically, to run the project. That means the project goes downhill, and the tenants get hurt.

If HUD decides to foreclose, the owner may hide behind bankruptcy.

So that is the logic that HUD has used for a long time to essentially take very few enforcement actions. What we decided to do in the Office of Inspector General some few months ago was to make this a focus of our efforts.

We had done over the last 3 years some 37 audits of these insured mortgages and equity skimming. We found equity skimming in the 37 audits. We thought we had found $47 million in equity skimming. The Office of Housing agreed with us that there was

$22 million in equity skimming. And do you know how much HUD recovered of that $22 million? Four million dollars.

And the reason for that is the resources that you are talking about recovering are project resources. The question is how do you get to the owners. So what we decided was that there is a criminal equity skimming statute, there is a double damages civil statute, and action under those statutes can be taken, obviously, against the individual owners and managing agents.

We therefore have decided that even if we do not know what the total universe of this problem is, we know it is bad, we know it is going on. We know that these owners can pretty much count on HUD not taking enforcement action. So this is what we did. We went to every United States Attorney in this country, and we explained to them what equity skimming is, and how we needed their help, and the trouble we have been having trying to get criminal action. We got their pledges of support. We decided that we needed enforcement action. We do not need to issue audit reports. We do not need to cover the waterfront.

We are now having our auditors going in, looking at projects and looking specifically for equity skimming. Instead of issuing audit reports that typically are issued to the program officials and are negotiated over a period of years, we are going straight to the U.S. Attorneys with our findings.

It is our intention to get criminal prosecutions, to get civil judgments, and to get out-of-court settlements. We believe very strongly that we need to send a message to this community, which is a relatively small community of people who own these projects, that if they engage in this behavior, then we are going to get them, and we are going to get them personally.

Today we have been extraordinarily successful. In the past, we have had success in very, very few cases. We have now identified 117 potential cases of equity skimming. We have referred some 70 of those to United States Attorneys; 50 of those cases have been accepted for criminal and/or civil prosecution. We are talking, again, about a total of $92 million in equity skimming.

I would say to you that that is fine, and that this is a very, very significant effort on the part of the IG. It is one of the three points of our Operation Safe Home. It is a tremendous investment of our staff resources, and we have done it because we believe this is a systemic problem, and someone has to step up and try to stop it; but I do not think that you should think, nor should Mr. Retsinas think—nor do I think he does—nor should the IG think that this is an IG problem. In the first instance, it is a programmatic problem, and programmatic strategies have to be devised to deal with it.

There are some things that are underway, that have happened. There have been changes recently in the property disposition statutes that make foreclosure a more viable alternative for FHA. There is pending legislation in the Senate that would allow, in the event that HUD wanted to default on a Section 8 contract, this legislation would allow HUD to recapture that funding, to provide it to the tenants individually or to another project, so we simply do not lose that amount of housing from the inventory.

The IG believes that in addition, the design of this program needs to be reconsidered in fundamental respects. We need to consider the owners' equity and whether there should not be an increased equity as a disincentive to equity skimming. We think that we should together look for ways to increase personal liability of owners and agents for equity skimming. We should probably be looking at tax credits for owners who infuse money into the projects.

There are in addition a whole series of enforcement tools that can be improved, can be refined; the Bankruptcy Code; civil money penalties; extending existing statutes to new programs. There are a whole series of things, and we have been working with members of this Committee to try to come up with those better enforcement tools.

Chairman GLENN. Let me ask, if I could, when you use the term, "equity skimming," does this always indicate fraud? Is there automatically fraud in equity skimming, where they are taking money out of this that is part of the recoupment of their investment and so on—is part of it legal, or is equity skimming always fraud?

Ms. GAFFNEY. As we are talking about equity skimming, it is defined—"equity skimming," the term, is in criminal statute, and it is a criminal offense.

Chairman GLENN. So it is just stealing, then.

Ms. GAFFNEY. It is stealing. Now, in the broader civil sense, it is the improper, illegal use of funds. So any time we are talking about equity skimming, we are talking about wrongful behavior.

Chairman GLENN. How many cases have you referred to Justice on this; how many cases have been prosecuted on equity skimming?

Mr. GREEN. Over the years, we have had very few criminal prosecutions, if that is what you are talking about; a handful, five to 10, over the last 10 years.

Chairman GLENN. How many?

Mr. GREEN. Five or 10 over the last 10 years. I am talking about criminal prosecutions.

Chairman GLENN. Why so few?

Mr. GREEN. Because it is a white-collar crime case, a paper case. It is very difficult, first of all, to get U.S. Attorney interested because it takes a great deal of time, it lacks jury appeal; there is a whole series of reasons, most of them probably justifiable.

We cite in our statement a case in Kansas City, Kansas and Missouri—a combined case out there—that we did an audit report in 1989, and now, 5 years later, in July, the owner of that project has finally gone to jail. It took us a good 2 years of solid investigative work to get the U.S. Attorney prepared to bring that case.

Chairman GLENN. Why so little interest? We have got billions involved here, don't we?

Ms. GAFFNEY. Yes.

Chairman GLENN. What is your estimate on equity skimming?

Ms. GAFFNEY. Six billion, worst scenario.

Chairman GLENN. Six billion, and nobody is interested?

Ms. GAFFNEY. And that is highly speculative. But you know, Senator, I think one of the things that we have learned since we made a decision to go after this particular area is that you need to give

the U.S. Attorneys credit. If they have no background in this kind of case, if they have no background in housing law, then if you want them to prosecute cases, you have to put yourself out and educate them; you have to sell your product to them. That is what we have done, and to tell you the truth——

Chairman GLENN. Well, you can do a lot of educating for $6 billion, it seems to me.

Ms. GAFFNEY. That is right, and they have been very receptive, very receptive. In particular, there is an affirmative civil enforcement program at Justice now, and they are very, very eager to go after these cases.

Chairman GLENN. Were you finished?

Ms. GAFFNEY. The last thing I wanted to say is that Mr. Retsinas has convened an enforcement task force that we are participating in, and I would just like to say that I do believe it is critically important that, through that task force, we find ways that, apart from the IG efforts to get prosecutions, HUD takes a programmatic stance on enforcement that the industry will recognize and understand.

Chairman GLENN. Fine. Thank you.

Mr. Retsinas.

TESTIMONY OF NICOLAS P. RETSINAS,[1] ASSISTANT SECRETARY FOR HOUSING AND FEDERAL HOUSING COMMISSIONER, U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, ACCOMPANIED BY CONRAD EAGAN, SPECIAL ASSISTANT TO THE COMMISSIONER, HUD

Mr. RETSINAS. Thank you, Senator, and thank you for this opportunity.

With me this morning is Conrad Eagan, who is a Special Assistant to the Commissioner. He has an extensive background in housing development and really has spearheaded much of this effort.

At the outset, I would like to submit a written statement for the record.

Chairman GLENN. Your entire statement will be included in the record.

Mr. RETSINAS. Thank you, Mr. Chairman.

I will make a couple of opening comments and just summarize of the key points.

First of all, let me acknowledge my colleague, Susan Gaffney, our Inspector General, not only for her work in this area, but much more importantly for one of the points she made during her presentation, which is that audit reports are fine, and they are certainly necessary and need to be done and need to be reviewed; but sometimes the messages that are sent with audit reports are limited. So I certainly applaud the initiative not only for the extent of the evil that is uncovered, but more importantly for the message it sends, that this is more than just a technical violation of a statute; this is criminal, and it is absolutely inappropriate to divert funds that are intended to serve the public interest to private gain.

We define equity skimming perhaps a little differently, although I think we end up at the same place. From our point of view, it

[1] The prepared statement of Mr. Retsinas appears on page 99.

is a diversion of funds that are intended for the project that accrue to the owner's personal or financial benefit.

Now, I might add parenthetically, Senator, that there are occasions where a diversion of funds on a temporary basis is appropriate. Let me give you an example of that.

For example, there could be an emergency repair at a particular project, and before the normal process of review is undertaken, it is necessary to borrow funds from the account to take care of that repair. So that is not what we are talking about. We are both talking about situations where it is inappropriate and illegal to divert funds.

What I would like to do for a few moments this morning——

Chairman GLENN. Just to clarify that, though, situations like that would be a tiny percentage of the overall funds we are talking about, I presume.

Mr. RETSINAS. A small number, but I guess I want to be careful because we also have to deal programmatically with the almost 20,000 mortgages that we have to make sure we encourage owners to take the proper behavior. So I want to make sure that we find a way, and I will describe in a second how we are going to do that; that in certain situations, owners make those kinds of judgments. Judgments that accrue to the direct, positive interests of the tenants are appropriate. Judgments that accrue to the pecuniary interests of the owners are inappropriate, and we need to do a better job of making those distinctions and getting greater clarity.

Chairman GLENN. OK. Fine.

Mr. RETSINAS. What I would like to do for a few minutes this morning is talk about some of the things we are now doing, some of the things we are planning to do, and also be as candid as I can, Senator, about how far we can go and how far we are not going to be able to go.

Let me say as a preface to that that I again would agree with Ms. Gaffney that one of our major barriers in bringing this problem under control and uncovering it in its fullest extent is the lack of appropriate staffing. I am one of the few individuals in the Government who has two responsibilities, two titles. One is the Assistant Secretary for Housing, which is to oversee housing policy and housing programs. In addition, I am the Federal Housing Commissioner, which means that I have oversight over the insurance funds. We have four insurance funds. We are talking about our general insurance fund and special risk insurance fund here, which is the insurance fund for our multifamily developments.

It is clear to me as an overseer of the insurance funds that sometimes it is better to spend money than to save money; it is better to engage in loss mitigation; it is better to engage the proper personnel to formulate the proper systems to ensure that there is proper oversight.

But Senator, as you know, we are bound by overriding, overarching governmental limits on staffing and on spending. And those limits, on a general, no one would argue with; everyone is against Government spending, everyone wants fewer Government employees. But when you are administering an insurance fund and trying to save money, sometimes you need to spend money to save money.

Just one anecdotal number, to give you an example of that, if I could, Senator. Before I joined the administration about a year ago, I was with a State housing finance agency, one like you have in your own State of Ohio. The normal ratio of staff to projects in those agencies around the country is one to 12, one to 14. The ratio in the HUD field offices is closer to one to 100. With that kind of oversight, it becomes difficult to put teeth into some of these devices that we will be talking about today.

Notwithstanding the extent of the problem, the depth and width of the problem, that is certainly no excuse for inaction. To the contrary, it ought to be and it is a motivation for me and my colleagues and Secretary Cisneros to take action. What I would like to do is give you some examples of what some of those actions are.

One, one of the best ways that we can address the issue of equity skimming is through prevention. We need to do a better job to make sure that the wrong people are not involved with our projects in the first place. I wish I could say that all developers, like all people, are good and honest; but there are some who are not. We ought to do a better job of screening who gets into our developments in the first place, in terms of ownership.

One of the technical ways we do that is through a process we call "previous participation," which means we check to see to what extent a developer who is requesting insurance has a record that is suspect, and we use that as an opportunity to keep that developer out.

Over the long run, we believe a more effective vehicle for making those kinds of decisions is through a program we call "risk-sharing," which is partnering with State and local housing agencies who are closer to the community and can have a better sense of the actual performance and past record of these developers.

We have initiated over the past year 33 such agreements; 27 with State agencies and with local agencies. We believe that is an important way of changing our delivery system and making it more responsive to local conditions.

The second preventive tool we have put into effect is a kind of early warning system. With the staff and resource shortages that I noted and that the Inspector General noted, it has often been difficult to assemble and accumulate the proper kind of information to do the kind of reviews that are necessary. Within the last couple of months, we have entered into a financial statements contract. In the absence of staffing, we have had to go outside and, through contract, engage the contractor to accumulate and assemble financial statements on all of our multifamily projects. That is literally a work in process.

We believe that with that information, it allows us to strategically place our limited employees, so we can tell them what to focus on, given they cannot focus on everything; there just are not enough of them. But with better information, we can be more tactical and more surgical about where to pay attention.

In a similar vein, perhaps our major problem among our inventory and portfolio is the formerly coinsured projects. Senator, as you may recall, this was a major problem with the Department in the 1980's; it led to major losses. In the previous administration, this program was suspended. We have certainly not revived this

program, and we continue to work out the substantial losses to the Government.

In this contract, we have engaged a contractor, again, to help assemble the necessary information so we can take the necessary corrective action that the Inspector General refers to.

The fourth area I want to speak to is one I mentioned in my opening comments, which is the subject of owner advances. Under limited conditions, there are situations where it is appropriate for the owner to use project funds. I mentioned the case of an emergency. A pipe breaks. Something needs to be done. And after all, we are the Government. It often takes us a long time to give the necessary approvals. In those situations, we expect and want the owner to take the appropriate remedial action. We need to do a better job clarifying what is appropriate because sometimes the owners have used the ambiguity of our own rules and handbooks as an excuse.

One of the reasons that, as Chris Greer mentioned, it has been so difficult to formulate and present the cases is because owners have often used the HUD regulations and handbooks themselves as a defense. We need to be clearer in terms of what is allowed and what is not allowed.

Next, what we are trying to do is augment to the extent we can, given the resource limitations, the field staff we have. Secretary Cisneros recently authorized me to hire an additional 100 individuals in temporary positions, in what we call multifamily asset management. That will help. It will not completely do the job. We need more than that, and he knows that, but at least it will help. It is a step in the right direction. That, and with better training—and we recently completed a training session of 57 such technicians—with that, we think we will be able to make better use of this limited personnel.

The sixth area that I think will pay some dividends in the future is the area having to do with the structure of our field offices. Senator, as you may know, over the course of the past several months, Secretary Cisneros has unveiled a major reorganization of the Department. That reorganization will make our 81 field offices more accountable to the program offices. And the housing field offices, that will make them more accountable to me and thus will make me more accountable to the Secretary, who will be more accountable to you.

What we have had is layers of bureaucracy. We have had too many middle layers. We need more doers and less reviewers, and we think that with this reorganization, we will be able to make some progress. That reorganization will take some time, but I believe it is a step in the right direction.

In addition to prevention, there is some added enforcement that we think we can do. We certainly thank the participation of the Inspector General in our enforcement task force. Conrad Eagan has had a major responsibility in putting that together. It is the umbrella for much of the actions that we are talking about today.

I am concerned that the actions may be stymied again by lack of resources, so one of the things we need to do is make sure that there are actions we can take today. We cannot wait for more re-

sources given the budgetary limitations that exist, and we need to take some actions today.

In addition, we are now working with your colleagues in the Senate on the authorizing committees to get additional language to assist us in the area of civil money penalties. We believe the definition now is too narrow. There are too many ways to work around that definition. There are affiliated companies, there are management agents, who are sometimes—again, in the minority of cases, but sometimes—culpable. And we need to have a greater reach.

We think that the legislation that is now wending its way through the Senate will achieve that if it goes through resolution.

Susan Gaffney also mentioned before but I want to acknowledge, because it was important, and thank you, Senator and your colleagues in the Senate—earlier this year, you passed property disposition legislation that gives the Department more flexibility. Before that legislation was passed, we were faced with the situation that if we saw inappropriate actions, the ultimate stick we could use was withdrawal of the tenant assistance. Well, that may sound good, but not if you are a tenant; it is not so good. As a result, we were stymied. We could not afford to victimize the tenants in an effort to punish the owners.

We believe now, with this legislation, we can switch the subsidies, the vouchers, to other projects. That allows us again to properly address the problems of the owner, but not victimize the tenants. That legislation was just passed and signed by the President within the last 2 months, and we believe that that will be a great help.

In addition, you are now considering in the Senate—and we believe it has merit, and we believe that it can further make our work more effective—you are considering changes to the bankruptcy laws. Very often in this country—it is a very litigious country, Senator, as you know—people have used the bankruptcy laws as a way to avoid appropriate corrective action. We believe that with some changes that we are working with your colleagues in the Senate on, that we can find a way to make sure that bankruptcy does not become an excuse for inaction.

Bankruptcy is an appropriate legal procedure, but it ought not to be an excuse to avoid what is inappropriate before. We are working closely with your colleagues in that regard.

In addition, there is other legislation that is under consideration or will be under consideration that we think merits consideration. These items are complex, but that does not mean we ought not to consider them.

We talked before about the impact of the property disposition legislation. We think that is a major step forward, a major step forward. We believe, however, that that same kind of authority—that is, the authority to change and remove the Section 8 contracts—ought to be considered even if we do not go as far as actually taking over the property. We believe that that legislation has merit; it gives us one more tool. We need all the tools we have.

A second item that we have been discussing with Treasury on a very preliminary basis is the whole notion of exit taxes. Again, there are some owners that we believe ought not to be owners. There are some owners who really have not done the kind of job

they need to do. However, even some of those owners who would like to get out of the business find it difficult because of our Tax Code. We believe there are some things that could be worked on. We have had preliminary conversations with Treasury.

This is not intended to be a bonanza to existing property owners, but we think in selected situations, we should remove barriers to bad owners leaving their properties, so we can find the opportunity to put good owners in place, preferably owners who are affiliated with community-based organizations.

Finally—and this is a resource issue—the real problem—equity skimming is a real problem; I am not going to in any way try to minimize that problem—but the real problem is the condition of the properties and the conditions that our tenants need to live under. This Department, this administration, this Congress, need to understand that if we want to address living conditions in those properties, it is going to cost money. It is going to cost money in terms of necessary repairs. Absolutely, we should prevent equity skimming. Absolutely, we should make sure that the money goes to its intended use. But at the same time, if we really want to address the situation, we need to understand that perhaps a larger agenda needs to be set forward.

Over the course of this past year, we have been putting together that larger agenda, and we hope to have the opportunity in the days and weeks and months ahead to present it to you for your consideration.

Chairman GLENN. Good.

Mr. RETSINAS. Mr. Chairman, I would be happy to answer any questions you may have.

Chairman GLENN. Thank you. On your last point there, I have always thought that the people who go into these housing projects have a responsibility also to keep them up.

Mr. RETSINAS. Absolutely.

Chairman GLENN. I know we have one near where I live in Columbus that went downhill. It was a nice property, a good property that had multifamily, apartments, and other buildings. It was a very nice area, but it was only about 3 years before the windows were broken out, with cardboard over the windows, beer cans outside, and so on. I do not know how you enforce that sort of thing, but there is also a responsibility here, it seems to me, that we ought to be inculcating in the people who inhabit these places, but I do not know how you do it.

Mr. RETSINAS. Well, let me give you a suggestion if I could, Senator. I think you are absolutely right. One of the strategies that we are trying to undertake is we believe the best kind of enforcement in those situations are the fellow residents, because they are the ones who are most negatively affected.

So we believe that the more we can get resident involvement, the more we can have residents understand that they have a stake in the activity and behavior of their neighbors, the better off we are going to be. That is what I think is the best strategy to address that kind of issue.

Chairman GLENN. We are going to have to wind down, and we will submit some additional questions to you for your response in

writing, because I will not be able to get to all of these, but let me just run through a couple.

Mr. Retsinas, I know some of these cases of equity skimming were first identified by your office in local field offices, and I know you have taken a proactive approach, but the IG has had to get in and do some of these things as well out there, apparently, which is a little unusual for an IG to be out filing suits someplace out in the field. Is this something that you just do not have the people to do all the things that have to be done, or what?

Mr. RETSINAS. Oh, we certainly do not have the people to do all that needs to be done, but even if we did, I always welcome the support of my colleague.

Chairman GLENN. Yes, I know, but I am thinking there are lots of other things I would like to have her looking into besides having to be out filing suits in Federal court all over the countryside. That is not supposed to be the normal operation for an IG. She is stepping in because of the inadequacies of fouling up on the programs in the Department, basically, as I understood it.

So do you just not have enough people, and are you having to cut further under the 250,000 across Government that are being cut?

Mr. RETSINAS. There are resource shortages, and as a result of those resource shortages, there have been freezes on employment, and we have had a substantial reduction in staff, yes, Senator.

Chairman GLENN. Do we even know what the problem in equity skimming is, because as I understand it, we have never really gotten all the figures together and brought them in and put them together for the countryside as a whole. We have the different regions of the country that have their own equity skimming problems out there, and we have never yet put the whole thing together as a picture that lets us know what the overall equity skimming problem is. Is that correct?

Ms. GAFFNEY. Correct.

Mr. RETSINAS. Correct.

Chairman GLENN. Mr. Retsinas, it is your Department. What——

Mr. RETSINAS. That is correct.

Chairman GLENN. Why have we not done that? It seems to me that determining the extent of the problem would be number one.

Mr. RETSINAS. Well, first of all, any problem that exists ought not to exist. There is no question about that. So no matter what it is, whether it is a single dollar or the $6 billion that exists. I would hope with the contract I mentioned on the financial statements, we will get a better handle on what that problem is.

Chairman GLENN. Now, are you requiring the people to submit this information to you now; that is the point.

Mr. RETSINAS. Yes.

Chairman GLENN. You are now getting the information submitted from all over the country?

Mr. RETSINAS. Yes.

Chairman GLENN. So that in a short time, we should be able to have a little better handle on what the overall problem is; is that right?

Mr. RETSINAS. With the engagement of that contract that I referenced in my testimony, we will be assimilating that information.

We will still be making some guesses, of course, some estimates, but we will have the basic information for the first time.

Chairman GLENN. As of September 30th of last year, FHA had established loan loss reserves of about $10.5 billion to cover future losses on insurance programs. I do not know whether that figure is still accurate, but is the Government really likely to lose nearly 25 percent on its insured loan portfolio—25 percent? We are in with a lot of bum folks if that is the case; we ought to be screening people much more carefully going in, it seems to me. Is that a real figure?

Mr. RETSINAS. That is a real—it is the audit. As a matter of fact, when I joined the administration last year, it was $11.9 billion. It has gone down about $1.5 billion in the last year, but it needs to go down farther.

Chairman GLENN. But the insured loan portfolio of the U.S. Government, about 25 percent of it we think is going bad; is that right?

Mr. RETSINAS. According to the audit, the multifamily—not single-family—the multifamily portfolio, they estimate that 25 percent is at risk; yes.

Chairman GLENN. Well, that is just—it is hard for me to see how we drift into a situation like that without somebody doing something about it.

Ms. GAFFNEY. Well, I would just like to go back to the program design that we are talking about here. You know, many of these people do not have a lot to lose. The program is designed in such a way that individuals do not necessary feel they have a lot to lose from walking away from these properties.

Chairman GLENN. Well, no, because nobody is going to get after them if they do.

Ms. GAFFNEY. They have relatively little invested. They have no personal liability. There is insurance——

Chairman GLENN. We either need to run it as a Government program, then, and administer it and try to run it, or get better people to represent us out there in building these projects; one or the other. I do not know which one we should go for, but——

Ms. GAFFNEY. Probably both.

Chairman GLENN [continuing]. If you are looking at losing 25 percent of our insured loan portfolio, that is a horrible indictment of how this program has been administered through the years.

Mr. RETSINAS. It certainly is, absolutely so. And when I came here, I testified before one of your colleague committees on that matter and pointed out the difficulties. And as I mentioned to you in my statement, one of the ways I think we can do a better job screening is finding better partners to help us screen. That is why I think the State housing agencies are good candidates for that.

Chairman GLENN. Is your inability to really follow through on these things and do the prosecuting out there that the IG is taking up on just because you do not have enough people out there to do it?

Mr. RETSINAS. I think it is a combination of that—these are all, as Chris Greer mentioned, sort of white-collar crimes, and are complex. And it is often difficult to get the attention from the legal authorities to build up the necessary case.

Chairman GLENN. They apparently just steal with impunity from these projects, though, because I think your written testimony, Ms. Gaffney, indicates the Department only collects about 20 percent of the funds from project owners who engage in equity skimming. In other words, we do not really go out and go after them. In any other line of business, I think we would be all over them, filing suits and hauling them into court and putting them in jail. That is not done here, I guess, except for what you are taking it on your own initiative to do.

The Department does not really get that much involved in these cases across country; is that right, Mr. Retsinas?

Mr. RETSINAS. No. We do get involved. We need to get more involved, and part of that is the augmenting of resources, absolutely, and why we have been supportive of the Operation Safe Home initiative and been a partner in that.

Chairman GLENN. OK. Thank you. We may have additional questions to be submitted. We have gone on a long time here today, and I appreciate your willingness to stick with us here this morning; I know you had other things you could be doing, too, as I did, also. I am roughly an hour late for where I was supposed to be.

Thank you very much for being here. We will submit other questions to you, and we hope for an early response so we can include it as part of the testimony.

Thank you. The hearing stands in recess subject to call of the Chair.

[Whereupon, at 1:05 p.m., the Committee was adjourned.]

APPENDIX

PREPARED STATEMENT OF SENATOR WILLIAM V. ROTH, JR.

Today's hearing focuses on problems of fraud in certain IRS and HUD programs, and in the student loan programs. Unfortunately, many of the concerns that will be raised today may have a familiar ring. This is probably not the first time these problems will be in the public spotlight, nor do I suspect it will be the last.

This is because certain of the underlying reasons for waste, fraud, and mismanagement in these areas seem to persist, as they do throughout the government—poor financial controls and the lack of managerial accountability for preventing the problems in the first place.

I know the Chairman shares my frustrations. We repeatedly hear the same kinds of problems in federal programs, year after year, even as we receive assurances from the agencies that the issues are being addressed by top management. Part of the problem, as the Chairman has often pointed out, is the constant turn-over by top management, even when there is-no change in administration. But a major factor, as I know he also agrees, is that few government officials seem to be held accountable, in any meaningful way, when money is lost. Unless the official was himself a party to fraud, there seems to be no managerial price paid for failure to prevent problems.

Sometimes the very design of a program invites problems. If that is the case, then the authorizing committees in Congress need to be told that—loud and clear. Congress shares a responsibility for ensuring that programs are structured in the most prudent way possible. But in the end, Congress cannot effectively micro-manage away waste and fraud. About the best it can do is give program administrators the proper managerial tools, and then conduct thorough oversight.

That is what we have done, and that is what this hearing is about. I would like to know two things generally from all the witnesses: first, are there any other managerial tools that you need enacted to avoid the repetition of waste, fraud, and mismanagement—and second, what is being done to hold the proper people accountable for allowing problems to occur?

I look forward to hearing the responses to these and other important questions today. Thank you, Mr. Chairman.

PREPARED STATEMENT OF JAMES F. HINCHMAN

Mr. Chairman and Members of the Committee:

We are pleased to be here today to discuss the Internal Revenue Service's (IRS) efforts to (1) control the growing instances of fraud in the electronic filing program, (2) safeguard taxpayer automated files from unauthorized access and manipulation by IRS employees, and (3) remove unnecessary risk from its computer systems environment. These matters are critical to ensure that IRS issues proper refunds, has reasonable assurance that the confidentiality and accuracy of taxpayer data are protected, and has adequate computer systems security.

In recent years, the American public has come to expect quick access to information and services when dealing with private sector enterprises and now also expects the same responsiveness with federal government transactions. Today's automated technology has greatly increased IRS' ability to deliver services and to access information faster. Along with this technology has come new and greater challenges to protect IRS' highly sensitive taxpayer data.

IRS has recognized the problems associated with electronic filing fraud, browsing of taxpayer files by IRS employees, and a wider range of computer security weaknesses. IRS has taken some steps and plans to take others to improve these areas. However, additional action and sustained emphasis are necessary to improve con-

trols over electronic filings and protect taxpayer information. This is especially important considering the upward trend in fraud associated with the electronic filing program, the unauthorized browsing by IRS employees of taxpayer files that IRS has identified as a problem in all of its regions, and the overall computer systems security risks IRS continues to face.

Electronic Filing Fraud is Growing

Electronic filing shows the potential benefit of a paperless tax filing system. However, IRS has not yet shown how such a system can be adequately safeguarded against fraud. Electronic filing began as a demonstration project for Tax Systems Modernization and was offered nationwide in 1990. With this alternative to the traditional filing of paper returns, taxpayers could receive refunds within 2 weeks. Since 1990, the number of individual income tax returns filed electronically has increased—from 4.2 million then to 13.5 million this year. IRS views electronic filing as a cornerstone of its future business vision, and the goal is to receive 80 million electronically filed tax returns annually by 2001.

While we support the need to modernize IRS and the movement to electronic filing, we are concerned about the growing instances of electronic filing fraud. We recognize that electronic filing is not the only sources of filing fraud. Fraud associated with paper filing is also a problem that has grown in recent years.[1] Further, electronic filing is not an avenue through which individuals can tap into IRS' tax data.

We agree with the electronic filing concept but stress the need for adequate systems security and controls to protect against fraudulent electronic returns. Thus far, the number of electronic returns identified as fraudulent in any 1 year has been relatively small—for example, in 1993, about 26,000 electronic returns were identified as fraudulent, worth over $50 million. However, the growth rate of such returns is high and it is unclear how much of the growth is due to an increase in fraudulent activity rather than an improvement in fraud detection. Even more troubling is the uncertainty as to how much fraud might be going undetected.

As of July 1, 1994, IRS had received 110.4 million individual income tax returns of which about 13.5 million were filed electronically—9.5 percent more than at the same time in 1993. By comparison, IRS reports show that 64 percent more fraudulent electronically filed returns were identified during the first 5 months of 1994 compared to the first 5 months of 1993—20,937 compared to 12,730.

If experience can predict future trends, many more fraudulent electronic returns will be identified by the end of the year. During the last 7 months of 1993, for example, IRS identified another 13,227 fraudulent electronic returns, bringing the annual total to just under 26,000. If the 64 percent growth rate during the first 5 months of 1994 remains constant during the rest of the year, the number of identified fraudulent electronic returns could increase to about 43,000 by the end of the year.

Electronic filing has made it easier for IRS to process returns because the tax information is submitted directly to IRS' computers. As a result, the paper return is eliminated and the time it takes to process a return is reduced. However, fraud detection is compromised because of the 2-week time constraint that IRS imposes on processing a return, the use of manual methods to identify fraudulent returns, and the lack of W–2 information to confirm wage earnings.

We have made several recommendations to improve IRS' controls over electronic filing fraud.[2] The recommendations, which I will now highlight, involved (1) improved screening and monitoring of persons and firms authorized to file returns electronically, (2) validations and editing in the electronic filing systems that would help prevent fraudulent electronic returns from being accepted, and (3) better detection of fraudulent returns that have been accepted.

Better Screening and Monitoring Preparers and Transmitters of Electronic Returns

One way to help prevent fraud is to ensure that only reputable preparers and transmitters file tax returns. To file electronically, taxpayers can either have an IRS-approved practitioner prepare and submit the return or take a return that has already been prepared to an individual or business that IRS has approved as a transmitter. Because some preparers and transmitters have been involved in

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[1] In 1993, IRS reported identifying 51,883 fraudulent paper returns. The kind of fraud being perpetrated on electronically filed returns is no different than that being perpetrated on paper returns—for example, the preparation of bogus W–2s claiming fraudulent wages and withholdings; thus, supporting a fraudulent refund claim or earned income tax credit.

[2] *Tax Administration: IRS Can Improve Controls Over Electronic Filing Fraud* (GAO/GGD–93–27, December 30, 1992) and *Tax Administration: Increased Fraud and Poor Taxpayer Access to IRS Cloud 1993 Filing Season* (GAO/GGD–94–65, December 22, 1993).

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schemes involving fraudulent electronic returns, we recommended in 1992 that IRS do more to check the backgrounds of persons applying to participate in the electronic filing program.

One step we recommended was that IRS obtain information from the Federal Bureau of Investigation (FBI) to identify preparer and transmitter applicants with prior criminal convictions. IRS is working with the FBI to obtain this information.

IRS can also rescind the electronic filing privilege of any electronic return preparer or transmitter who fails to abide by various operating requirements stipulated by IRS. The effect of this rescission authority, however, is mitigated by the absence of any servicewide procedure to prevent a barred preparer or transmitter from reapplying. To correct this problem, IRS is designing a system that can be used to screen preparers and transmitters.

Preventing Fraudulent Returns From Being Accepted

IRS does not adequately prevent fraudulent returns from being accepted. The aspect of electronic filing that most attracts taxpayers is the speed with which they can get refunds. That speed also makes electronic filing appealing to potential defrauders because IRS has less time to identify and stop questionable refunds once an electronic return has been accepted. One way to deal with the problem is to prevent questionable returns from being accepted. In this respect, electronic filing gives IRS an opportunity that it does not have with paper returns—the ability to verify the critical information on the return before accepting it and issuing a refund.

When IRS implemented the electronic filing system, it did not build in adequate validity checks to help protect against fraud. However, as the need for such checks became more apparent, IRS has implemented several. Now, before accepting an electronic return, for example, IRS verifies that the taxpayer's name and Social Security number on the electronic transmission match information in IRS' records. If there is a mismatch, IRS will not accept the return.

That validity check resulted in over 200,000 rejected returns in 1994. IRS does not know how many of the returns rejected through the various validity checks involved attempted fraud or how many were simply the result of errors by taxpayers or preparers in recording or transcribing names, Social Security numbers, or other data. Nonetheless, even with the various upfront controls and all of the rejections, the number of fraudulent electronic returns getting into the system and later being identified by IRS continues to increase.

Another potentially effective control would involve an automated comparison of wage data on tax returns with wage data provided by employers, which is not currently possible. Toward this end, IRS may have an opportunity to use partial-year data to at least verify that an employer/employee relationship exists and that the taxpayer's reported wages appear reasonable. To do this, IRS has been looking into the possibility of using quarterly wage data that employers submit to states for unemployment compensation purposes. In 1995, IRS plans to pilot such an effort in conjunction with the State of California. If use of this information proves feasible, IRS might be able to match three quarters of employer wage data against information on a taxpayer's return.

Detecting Fraudulent Returns

After returns are accepted, IRS uses computer screening criteria to identify questionable returns. These returns are then referred to analysts for various levels of review. This is a slow, labor intensive process that is not automated. The screening criteria are broad and generate many more questionable returns than can be reviewed by analysts, creating a backlog.

Despite the amount of effort devoted to this nonautomated review, relatively few fraudulent returns are actually identified. For example, of approximately 3 million potentially fraudulent returns IRS reviewed in 1993, almost 26,000 or less than 1 percent, were determined to be fraudulent.

IRS is taking steps to improve its screening/review process—steps that may produce more exacting criteria that better identify potentially fraudulent returns and help analysts do better in reviewing those returns. The major effort in this regard is a 4-year, four-phase initiative involving IRS and the Los Alamos National Laboratory. In the first phase, which was piloted in the IRS Cincinnati Service Center in 1994 and is to be implemented nationwide in 1995, IRS automated existing processes to, among other things, provide for on-line review of questionable returns and provide an interface to on-line databases to verify information on the return. The other three phases are expected to result in more sophisticated methods of detecting fraud and refining criteria for screening fraudulent returns for review.

THE RISK OF IMPROPER ACCESS TO TAXPAYER DATA CONTINUES

In August 1993, we testified before this Committee that IRS did not adequately control access authority given to computer support personnel or adequately monitor employee access to taxpayer information.[3] For example, in 1992, IRS' internal audit found that some employees had used their access (1) to monitor their own fraudulent returns, (2) to issue fraudulent refunds, and (3) to inappropriately browse through taxpayer accounts. We also reported on this matter as part of our audits of IRS' financial statements for fiscal years 1992 and 1993 under the Chief Financial Officers Act (Public Law 101–576).[4]

In its examinations of all of its regional offices, IRS found similar problems. IRS also reevaluated the disposition of the Southeast Region's suspected browsing cases. Of the 328 cases analyzed, the IRS Office of Ethics agreed with the disciplinary actions in 213 cases and disagreed in 83 cases. For the remaining 32 cases, the IRS Office of Ethics was unable to determine the appropriateness of the disciplinary action because of inadequate information.

Overall, the Office of Ethics concluded, and IRS management agreed, that the disciplinary actions in 51 of the 328 cases reviewed, or about 16 percent, were too lenient. Moreover, the Office of Ethics found cases of inconsistent punishment for similar offenses, including disparate treatment between offices and within the same office. In this regard, IRS revised penalty guidelines to set minimum and maximum penalties for violating computer security and privacy laws. The guidance provides important assistance to managers to encourage fair and consistent application of penalties.

An internal systems security study commissioned by IRS in 1993 pointed out that one of the greatest risks to security is from employees. Nevertheless, a December 1993 review by IRS' internal auditors found that there were virtually no controls programmed into the Integrated Data Retrieval System (IDRS) to limit what employees can do once they are authorized IDRS access and authorized to input account adjustments. The review indicated that IRS' internal security program had identified instances of employee attempts to embezzle funds using IDRS. IRS has planned corrective actions to limit the adjustments to an account, record details of each account transaction, and report unusual and high risk account adjustment activity.

IRS officials told us that some employees were confused and uncertain about whether IDRS security rules applied in certain circumstances and were unclear as to what actions constituted an improper access or unauthorized conduct. IRS has taken steps to better inform and educate employees on their responsibilities concerning IDRS security and privacy issues. These steps have included distributing articles and newsletters, showing videos, and forwarding a message from the Commissioner—all of which emphasize IRS' policy regarding proper use of tax data. We endorse these actions and in addition, believe that IRS needs to consistently apply appropriate penalties and publicize all disciplinary actions to heighten employees' awareness of security rules.

With the technology available today, unauthorized access to taxpayer accounts can be restricted with systems controls. IRS' August 1993 action plan to address security weaknesses in IDRS is attempting to move IRS in this direction. For example, IRS reports that it can now use system controls to detect and intervene if employees attempt to access their own accounts or those of their spouses. Similar restrictions are not yet implemented to control employee access to the accounts of others, such as neighbors, relatives, or celebrities.

IRS needs effective systems controls to not only restrict access to necessary taxpayer accounts but to record audit trails of virtually everything that goes on with taxpayers' accounts. Managers have the responsibility to monitor the use of the system to make sure it is secure. Since their time is limited, it is important that exception reports provide managers only the information needed to investigate potential problems. Such reports are planned as part of IRS' new Electronic Audit Research Log system.

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[3] *Financial Management: First Financial Audits of IRS and Customs Revealed Serious Problems* (GAO/T–AIMD–93–3, August 4, 1993).

[4] *Financial Audit: Examination of IRS' Fiscal Year 1992 Financial Statements* (GAO/AIMD–93–2, June 30, 1993), *IRS Information Systems: Weaknesses Increase Risk of Fraud and Impair Reliability of Management Information* (GAO/AIMD–93–34, September 22, 1993), and *Financial Audit: Examination of IRS' Fiscal Year 1993 Financial Statements* (GAO/AIMD–94–120, June 15, 1994).

IMPROVING IRS' OVERALL COMPUTER SYSTEMS SECURITY

Following the August 1993 hearing, we not only reviewed IRS' planned actions to correct IDRS' security problems but also made an assessment of the Service's overall computer systems security. IRS' overall computer controls do not yet adequately ensure that taxpayer data are adequately protected from unauthorized access, change, and disclosure or loss of operations due to disaster. Serious risks are not limited to the use of IDRS, but apply to other IRS systems which also provide access to taxpayer data. We found the following to be the principal weaknesses.

—Inadequate control over access to computer systems. IRS' systems do not adequately prevent unauthorized access, which leaves taxpayer data at risk of illegal disclosure or alteration.
—Limited monitoring of taxpayer account transactions. Access to tax accounts may not be recorded, or if recorded, provide insufficient information to investigate possible unauthorized access.
—Poor contingency preparation for recovery after a disaster. This could leave IRS unable to provide basic tax processing services.
—Improper management of software changes. This creates a risky systems environment where the systems could be sabotaged.

The details surrounding these problems and our recommendations for corrective action are being reported to the Committee separately and will be limited to official use only.

None of our overall computer systems security findings was new to IRS. In its 1993 Federal Managers' Financial Integrity Act report, IRS added security over taxpayer data as a material weakness. Over the last several years, IRS has commissioned a number of studies which have revealed these and other serious systems security problems. IRS is moving closer to resolving some of its long-standing computer security problems; but until the solutions are actually in place, serious risks remain.

Given the extent of the automated systems weaknesses, we advised IRS to conduct a comprehensive systems risk analysis that would identify the security vulnerabilities in its mission-critical operations and include the computer systems and the networks that connect them. We believe such an analysis is needed to ensure that all the major risks have been identified. Also, the analysis would enable IRS to determine whether the planned actions are sufficient to bring its computer security under adequate control.

IRS has demonstrated a strong commitment to improve control over access to its taxpayer records. Much of what IRS considers as its solution to its computer security problems is imbedded in the Tax Systems Modernization effort, which is 6 or more years away from completion.

Today's risks, however, cannot be left for a future system to resolve, and there are actions that can be taken today to secure IRS' computer systems. Implementing better automated systems controls through some of the technology options now available will require resources. Thus, IRS' managers face difficult but important decisions, such as deciding how many resources to devote to systems security in the current environment, given the commitment to Tax Systems Modernization.

* * *

Mr. Chairman, IRS is at a critical juncture—automating tax services is the essence of Tax Systems Modernization and IRS' ability to carry out its mission. This creates an entirely new set of challenges in managing IRS—controlling fraud and access to taxpayer data in an electronic age where technology is rapidly expanding. IRS is working to better control electronic filings and the great risk of unauthorized access to taxpayer account data and to improve overall computer systems security. IRS understands many of its underlying computer security weaknesses; but at the present time, serious and long-standing weaknesses remain. Adequately reducing the risk in these areas will depend on the prompt and effective implementation of significant computer systems security improvements. The continued oversight and support by this Committee in tackling this difficult challenge will also be most important.

This concludes my statement. We would be pleased to respond to any questions you or members of the Committee may have at this time.

PREPARED STATEMENT OF MARGARET MILNER RICHARDSON

Mr. Chairman and Members of the Committee:

With me today are Mike Dolan, Deputy Commissioner, and Ted Brown, Refund Fraud Executive, formerly the Assistant Regional Commissioner, Criminal Investigation, Central Region.

We appreciate the opportunity to be here today to discuss the Internal Revenue Service's commitment to detecting and preventing attempts to undermine our tax system of voluntary compliance by those who are unwilling to comply with the tax laws. Our goal is to maintain a balanced enforcement program that ensures compliance among all groups of taxpayers while safeguarding taxpayers' rights and privacy. We also appreciate the opportunity to update you on our progress in safeguarding taxpayer files from unauthorized access and manipulation.

Traditionally, we have accomplished our goal of ensuring compliance among all groups of taxpayers through broad-based enforcement of the tax laws, the Bank Secrecy Act and money laundering statutes by our Criminal Investigation Division (CID), the criminal tax investigative arm of the IRS. Our Special Agents are widely recognized experts in investigating financial fraud. White collar financial crimes, such as tax fraud, bankruptcy fraud, and motor fuel excise tax crimes are among CID's top enforcement priorities.

Today, we would like to share with you our current activities and long-term strategies for addressing tax refund fraud—one element of tax fraud. Both the electronic and paper filing systems are subject to continuous attempts by fraudsters to circumvent fraud control mechanisms. Our initiatives are, and will be, directed at protecting both the electronic and paper filing systems since both are exposed to yearly fraud attempts. However, only when we have implemented our Tax Systems Modernization (TSM) program will the IRS have the computing systems and capacity needed to install sophisticated fraud control mechanisms that will prevent fraudulent refund claims from entering the system.

I. Introduction

Fraud is not unique to the government or the IRS. Technological advances have significantly improved both public and private institutions' capacities to deliver money faster. Prompt payment is a desirable customer service goal, but, for an agency such as the IRS, it can present problems from a law enforcement standpoint. Efforts to shorten payment cycles and to dispatch electronic payments rapidly must be matched by corresponding safeguards to ensure adequate controls. While the IRS also wants to provide quality service that will include prompt payment, and we are moving towards this goal through modernizing our technology, we have to ensure the integrity of the tax administration system and be concerned about improved compliance as well.

The IRS has addressed tax refund fraud through its Questionable Refund Program (QRP), which began formally in 1977 in response to perceived abuses of the system. In 1977, the CID had the primary responsibility for QRP. The program was conducted in each of the ten service centers, where teams of trained personnel reviewed pre-refund tax returns which had been selected manually or based on computer criteria. From 1977 to 1990, the IRS identified a relatively modest number of fraudulent refund claims per year. Generally, these claims involved individuals who tried to file more than one return by using another person's Social Security Number (SSN) or by simply creating SSNs and other fictitious supporting documents.

In response to a number of factors and emerging trends, the IRS has designed a new multi-functional approach to control refund fraud utilizing new technologies. These increased efforts from 1990 to present resulted in significantly more fraud identified and stopped by the IRS, as well as the identification of a number of new schemes. The new schemes frequently involve perpetrators who set up schemes, whereby they recruit individuals to file false claims. Other schemes involve a few unscrupulous return preparers and Electronic Return Originators (EROs) who are responsible for many false claims.

Our fraud reduction strategy encompasses the understanding of fraud, as well as prevention, detection, and enforcement. All four elements are essential for effective fraud control. Before detailing our strategy, I want to discuss some examples of refund fraud.

II. Filing Fraud Studies

Understanding the fraudulent schemes confronting us, a key element of preventing fraud, is not always easy. The statistics most readily available have limited

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value because they are taken from existing fraud detection operations and obviously cannot include undetected fraud.

The known statistical indicators must be cited with caution, since they can be easily misunderstood. For example, from January 1 though May 31, 1994, the number of fraudulent refund returns detected was approximately 53,100. At that rate, we anticipate twice as many fraudulent returns will be detected in 1994 as were detected in 1993 (77,800 returns). The dollar aggregate for fraudulent refunds detected during that 5-month period exceeded $99.4 million. We are continuing to analyze these statistics to further assess the extent to which these detection figures represent a dramatic increase in the rate of fraud attempts, an improvement in IRS detection capabilities, or a combination of both.

To enable a more comprehensive analysis of the extent of refund fraud, we initiated three studies during this filing season. Statistically valid samples, including paper and electronically filed returns from all income levels, are being used for these studies.

The first study has been completed. In that study, we selected a small, statistically valid sample of approximately 1,000 returns filed electronically during January 1994 which claimed the Earned Income Tax Credit (EITC). The EITC claimed was verified by IRS Special Agents through personal contact with taxpayers, return preparers and employers. The study showed:

- Roughly, 35–45 percent of 1.3 million returns with EITC claims filed electronically through January 28th would, because of errors, have been adjusted by either increasing or decreasing the credit claimed, if they had been examined. These percentages may be understated because 18 percent of EITC returns filed electronically were rejected, before they were filed, due to fraud detection measures.
- Approximately 50 percent of the EITC claims with errors appear to have resulted from unintentional errors; the errors in the remaining 50 percent of the returns appear to be the result of intentional misrepresentations in order to qualify for EITC.

Additional taxpayer characteristics gleaned from this study will assist in identifying potentially fraudulent claims by aiding in the development of additional fraud controls.

The second study involves the selection of a moderately large sample of returns transmitted by Electronic Return Originators (EROs). The data gathering phase of this study is underway. For the third study, we have selected a large statistically valid sample of refund returns filed throughout the 1994 filing season. The sample includes returns filed on paper and electronically. Results from the third study will be used to expand our understanding of issues identified in the first study. Field work for this last study is scheduled to begin in August 1994.

III. Fraudulent Schemes and Investigations

The QRP team has detected schemes involving tax returns claiming fraudulent refunds based on the misrepresentation of Federal income taxes withheld and refundable credits. Those schemes involve taxpayers who:

- use their own names and SSNs;
- use names and SSNs of unsuspecting legitimate taxpayers; or
- use totally fictitious names and SSNs.

Some specific examples of fraudulent schemes we have detected are:

A) Unscrupulous return preparers/EROs

Two owners of an income tax return preparation firm in Salinas, California, obtained SSNs and names of area agricultural employees from their clients' payroll records. Unknown to the agricultural workers, the two preparers submitted over 200 tax returns claiming more than $165,000 in fraudulent refunds. The QRP team uncovered this scheme when it detected irregularities on the fraudulent returns along with the discovery that the workers began filing legitimate returns of their own. The preparers received substantial sentences of 37 and 18 months for their respective roles in the scheme and were ordered to pay restitution.

B) Fraudulent Motor Fuel Excise Tax Credits

This scheme involves creating fictitious corporations. False corporate tax returns (Form 1120) are filed reporting little or no tax liability, but claiming a large credit for Federal excise tax on fuel used for exempt purposes. The motor fuel excise tax credits that are claimed in these schemes have ranged from $5,000 to $60,000.

C) Individuals who recruit others to file false tax returns

Two rings operating in Jacksonville and Tampa, Florida, recruited their friends, families and associates to file false tax returns. The scheme involved real people using their own SSNs, but the Forms W–2 had false wage and withholding information. The ring also used non-existent companies or claimed wages from companies where the filers were never employed. This scheme was identified when similarities among returns were detected by the QRP team. Over $400,000 in false claims were involved, and 28 people were charged in the conspiracy to perpetrate this refund scheme. Most have pled guilty and have received substantial sentences.

D) Prisoner Schemes

Each year there are prisoners who attempt to defraud the tax system. For example, an inmate in a Colorado prison contrived a refund scheme to file three false claims for refunds totalling $20,000. The inmate prepared and submitted Forms W–2 and tax returns after obtaining other prisoners' SSNs and names. The other prisoners were paid a commission for allowing these returns to be filed using their names and SSNs. The inmate received 10 more years to serve in prison for this scheme. Through systemic checks we have regarding prisons, the IRS is able to identify such schemes.

E) Use of False or Nonexistent Documentation

One of the more sophisticated schemes involved an attorney who planned for 8 months to perpetrate a multi-million dollar scheme to file false income tax refund claims with the help of two other people. He agreed to pay a friend a fee of 20 percent of the proceeds to obtain the names and SSNs to be placed on the false returns; to assist in obtaining false identification for their use; to locate mail drops for mailing the refund checks; and to retrieve the refund checks when they arrived.

The second person was a payroll clerk of a large company, who helped steal the company's payroll printouts containing employee data.

The fraudsters established mail drops along the East and West Coasts using the false identification, and they mailed over 900 false returns claiming over $8 million in refunds to three different service centers assuming that the duplicate addresses would not be easily detected. However, because of the QRP team, this scheme was promptly identified and stopped.

Our detection systems also have intercepted false claims which reveal the following additional types of abuse:

- Claiming large amounts of false income and withholding for fictitious businesses to qualify for refundable credits.
- Using unidentified income, later determined to be welfare payments, as earned income to qualify for an Earned Income Credit-based refund. These funds are included on returns as other income or wages.
- Preparers knowingly file incorrect returns, with or without a taxpayer's knowledge, by adding non-qualifying dependents as exemptions or increasing deductions while diverting the refunds from the taxpayers.

These schemes represent some of the types of frauds that our detection systems have identified. They do not represent all of the types of schemes that we have detected.

IV. Fraud Reduction Strategy

A) Overview

Shortly after becoming Commissioner, I recognized the need to step up our efforts to detect refund fraud. I responded by appointing Ted Brown, who is with me today, as our Refund Fraud Executive to spearhead our enhanced efforts. Mr. Brown has 22 years of experience in our Criminal Investigation function and a strong background in fraud detection. He is a senior executive, who was serving as the Assistant Regional Commissioner (CI), Central Region, when I selected him. Prior to that he was the Assistant District Director in the New Orleans District and the Chief, CID in Dallas. In his new role, he has the responsibility for developing and overseeing all of IRS' efforts to enhance the detection and prevention of not only refund fraud, but also filing fraud in general.

Since our concerns extend beyond just prosecution of refund fraud, we recognize that our fraud reduction strategy must cross the Service's traditional functional lines. We have a four-part strategy utilizing new technology and multifunctional resources to:

- understand fraud;
- prevent fraud;

- detect fraud; and
- use enforcement tools whenever needed.

B) Understanding Fraud

Controlling fraud is a dynamic undertaking. Fraud is perpetrated by those who think creatively, adapt continuously, and relish devising complex strategies. These perpetrators have no single profile. Fraud prevention mechanisms which are perfectly satisfactory today, may be of no use tomorrow. Maintaining effective fraud prevention mechanisms demands continuous assessment of emerging trends and constant revision of the current prevention mechanisms.

Most of the more sophisticated fraud schemes are devised by persons skilled in computer programs and techniques. They assume the existence of transaction-level filters, and therefore design their fraud schemes so that their returns would pass through the system unchallenged. The individuals who devise such schemes seem to accept the constraints imposed by the system. The smarter ones test the system from time to time to make sure they roughly understand the parameters being used. With this information, they may increasingly generate multiple transactions and attempt to incorporate sufficient randomness or variation to minimize the risk of detection.

Fraud is not unique to government or the IRS. As government agencies and private companies have automated their systems, perpetrators of fraud have followed. While the IRS is always concerned with meeting its obligations to promptly refund monies to taxpayers who file timely and accurate tax returns, we will balance our efforts to timely issue refunds with adequate fraud control mechanisms.

C) Prevention

Prevention is the critical element of our strategy. Although detection and prosecution are important, it is costly and inefficient to prosecute every instance of fraud. Recognizing this, we will continue to build higher barriers to fraud—so that the IRS is viewed by criminals as an unattractive target. Our goal is to stop fraudulent returns from entering our systems.

We are instituting short-term and long-term systemic changes to reach this goal. One change implemented for the 1994 filing season was the elimination of the direct deposit feature on refunds issued to first time filers. These refunds were issued by paper check. Other prevention measures include our outreach and publicity program. For instance, at the same time we are increasing our publicity efforts to educate taxpayers and practitioners about the benefits of electronic filing, we recognize that we have a responsibility to make the public—including the practitioner and ERO communities—aware of the need to combat fraud.

We continue to build on our partnership with practitioners and Electronic Return Originators (EROs). We provide training to preparers and have designated Electronic Filing Coordinators in each IRS district. The vast majority of practitioners and EROs are interested in maintaining the integrity of our tax system; they recognize their responsibility to prepare, file, or transmit correct information to the IRS. Several of the major tax return preparers have initiated their own fraud prevention efforts, and we appreciate their efforts in working with us. However, when we identify those few unscrupulous practitioners and EROs abusing the authority of their position by committing fraud, we intend to pursue criminal enforcement to the full extent.

Combatting fraud requires not only systemic mechanisms to prevent fraudulent returns from entering our systems, but also the combined efforts of all our partners in tax administration—tax return preparers, tax practitioners, and Congress.

D) Detection

Our fraud reduction strategy includes a strong detection component. We are improving our current screening and detection systems with more sophisticated and automated techniques. I recognized fraud detection was a priority item when I became Commissioner. With key members of my staff, I visited the Los Alamo National Laboratory in Los Alamos, New Mexico, to see first-hand the creative use of artificial intelligence systems in detecting fraud.

The Los Alamos National Laboratory has 7,500 employees prepared to apply world class, scientific and technical talent to the solution of problems of national importance. The Laboratory's greatest strength, as it applies to the IRS' problems, is its ability to assemble teams of diverse, multi-disciplined technical staff to tackle all aspects of a complicated problem, integrate a solution, and deliver a responsive final product in a timely fashion. The Information Extraction and Analysis Team is experienced in collecting large quantities of data (like tax returns), identifying a sub-set of information that would be useful (for fraud detection) and integrating this infor-

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mation into existing or planned IRS systems. Through Los Alamos' Advanced Computing Lab, the resources of the world's most powerful high-performance computers are addressing the problem of fraud detection.

The Laboratory's research in nuclear weapons is widely known. But in more recent years, it has been called upon by other government agencies and private companies to lend its technical abilities to solving other important problems. The Laboratory has assisted many agencies in improving computer security and designing software to detect anomalies and match patterns in large data sets. Its assistance offers potential to aid the IRS in improving many areas including fraud detection, audit selection, computer security and market research. Specifically, we believe this assistance will improve our ability to identify fraudulent refund claims and to reduce expensive manual screening procedures. As we continue to identify the items on returns that are predictive of fraud, we will move these "filters" to the front of our processing system. Returns with these patterns can then be removed from normal processing and carefully scrutinized. In 1995, we have been planning to install a new electronic fraud detection system which will serve as a platform for the Los Alamos Laboratory systems.

Our detection capabilities have also been enhanced through the efforts of our Internal Audit function. Our Chief Inspector views refund fraud as a priority and has made it a significant piece of the Internal Audit work plans. Beginning with the 1994 filing season, Internal Audit has devoted substantially more resources to evaluating the efficiency and effectiveness of our fraud detection mechanisms. Internal Audit's intensified efforts will continue through the 1995 filing season.

Our current detection program depends on a pre-refund review of millions of returns selected by manual or computer criteria. Those returns having substantive indicators of fraud are referred to field offices for possible criminal investigation. Returns which do not merit criminal investigation are referred to other functions for civil action or processing.

The principal source of returns selected for review by the QRP teams is computer runs that apply weighted criteria against every refund return that is processed. The criteria are developed and refined yearly based upon previously identified false claim schemes, as well as potential abuses, identified by IRS personnel. They are capable of being modified so that data can be inserted when additional schemes or potential abuses are identified to allow cataloguing of the total scope of fraudulent trends.

In addition, the overall processing of returns by the IRS has certain built-in checks and balances that assist us in the identification of suspected fraudulent claims. All service center personnel, including data transcribers, are given fraud awareness briefings during their training so they can be alert to indicators of fraud. Throughout the returns processing pipeline, service center personnel designate suspicious returns for review by the QRP teams.

We use many internal as well as external sources of information in order to identify fraudulent returns. Each center has a team made up of 20 to 65 members during various times of the filing season. The additional staffing that has been allocated to the QRP teams has allowed them to review more returns and use a more analytical approach in the detection process. The additional staffing has also allowed for more interaction between our field agents and our QRP teams. This interaction facilitates early detection of fraud and stops many schemes. Our Returns Processing and Information Systems functions continue to expand their role in fraud detection, which has also contributed to the increase in detection of fraud.

E) Enforcement

A fourth component of our fraud reduction strategy involves the use of enforcement tools, such as prosecution, to deter criminal violations of the tax law. Public confidence in our tax system can only be maintained if tax refund fraud perpetrators know that they risk going to jail when they are caught. The IRS, working with the Department of Justice and U.S. Attorneys, will continue to actively pursue cases of criminal violations of the tax laws with every intention of prosecuting where appropriate. Our criminal enforcement effort has been very successful, and we will continue to work closely with the Department of Justice and U.S. Attorneys to be even more effective in the prosecution of fraudulent refund cases. Approximately 98 percent of the indictments involving refund fraud result in conviction, and the average incarceration time is 17 months.

Despite these successful convictions, we recognize that we cannot prosecute the problem of fraud away and that we need a broader multi-functional fraud reduction strategy. In some situations, we have successfully combined criminal prosecution with other compliance initiatives. For example, in a remote county in northern Florida, there was one tax return preparer for the county who prepared fraudulent re-

fund returns by claiming tax credits. The traditional method of handling such a situation would have been to audit all of the preparer's clients. In this situation, however, we notified the unsuspecting taxpayers that they could have a potential problem with their tax returns. We set up taxpayer assistance sites at convenient times and locations and invited the taxpayers to come in for tax assistance and to do self-audits of their returns. Over 200 taxpayers corrected their returns and received some tax assistance to prevent the situation from recurring.

Although this approach is not appropriate in all cases, it worked very well in this situation. Efforts like this, as well as many outreach and educational efforts, are being used throughout the country.

F) Initiatives for 1994

In a continuing effort to reduce tax refund fraud, numerous systemic verifications were implemented for the 1994 filing season. These include additional comparisons of IRS data to confirm the identity of the taxpayers and the validity of their claims. However, it would not be appropriate to disclose the specific nature of these checks here, since to do so would reduce their effectiveness in protecting our system.

About 500,000 taxpayers had their refund delayed due to errors or omissions of required information on their EITC claim. These taxpayers were contacted and had to supply documentation to verify the questionable or omitted item before the refund was released.

Another systemic test is being performed by a cross-functional group of special agents, questionable refund detection team members, internal auditors, and electronic filing specialists. Although recently formed, the group's mission is to creatively challenge the system by developing schemes in which they believe they can file fraudulent returns and avoid detection. In this way, we can test our current detection systems and devise ways to change them if necessary.

G) Plans for 1995

While it would not be appropriate for me to discuss all of our fraud control measures for the 1995 filing season, there are two actions that we are undertaking that I do want to share with the Committee. First, we are tightening the standards for EROs. New standards under consideration include requiring first-time ERO applicants to submit fingerprints to the IRS which will allow us to obtain a criminal records check from the FBI; and authorization for credit checks by the IRS. Additional IRS field resources will be shifted to compliance checks of the ERO community and enforcement of the requirements for participation in the program.

Secondly, substantial efforts will be devoted to assuring that taxpayers claiming refunds use the proper TIN. To that end, we will direct significant resources towards identifying refund claims without a taxpayer identification number (TIN); with an invalid TIN; and/or with more than one taxpayer using the same TIN. Today, in order to withdraw money from a financial institution, you must use a correct account number or personal identification number. We believe that before monies are paid from the Federal treasury, taxpayers should also have to provide a correct, valid TIN. Failure to do so will result in a delay of the refund until the matter is resolved.

V. Proposed Systemic Changes With TSM

The actions that I have just outlined are significant steps we are undertaking to detect and prevent fraudulent refund claims. However, our Tax Systems Modernization program holds the key to identifying and stopping those who attempt to fraudulently circumvent the tax system. Without modern equipment and software, applying expert systems analysis to large data bases is virtually impossible. Tax Systems Modernization will not only provide the computing power and capacity needed to apply sophisticated fraud detection techniques, but it will also provide us with more timely access to more information.

Mr. Chairman, let me provide you with some concrete examples of how Tax Systems Modernization will improve our ability to detect and prevent fraud:

- Through our Document Processing System (DPS) which is currently being developed at the Austin Service Center and is scheduled to be piloted next year, we will be able to capture all of the information on paper tax returns compared with only 40 percent that we capture today through the labor intensive, manual input process. This will enhance our ability to identify fraudulent returns by enabling systemic cross-checking of more information on the return, as well as with other returns. In addition, through the efficiencies of DPS we will also be processing this information faster and making it available for use by front-line compliance personnel.

- Beyond DPS, other major TSM systems such as the Corporate Accounts Processing System, Workload Management System, and Service Center Support System will combine to provide us with numerous fraud control features such as the capability to accelerate third-party document matching, so that a tax return can be matched against third-party information before a refund is paid. This change will have enormous impact in enabling us to detect and stop fraud before it takes place, and will significantly accelerate the collection of more than $3 billion in annual revenue.

Through these and other TSM projects, the IRS will be able to make dramatic improvements in tax administration and significant inroads in our fight against fraud. Such significant inroads cannot be made, however, if funding for these projects is delayed or not available.

Mr. Chairman, while I appreciate the difficult financial choices that Congress must make concerning the fiscal year 1995 appropriation bills, I feel strongly about the need for more funding for Systems Modernization. Unfortunately, as of today, significant reductions in TSM funding for fiscal year 1995 appear to be likely. Such reductions, unless they are largely restored, may require us to stop all of the major hardware acquisitions we had planned and, consequently, completely rethink the Tax Systems Modernization program we have planned.

Mr. Chairman, the assistance of you and your Committee in doing whatever it can to obtain the necessary fiscal year 1995 funding for our modernization efforts would be greatly appreciated. With your continued support, we hope to be able to sustain the momentum of Tax Systems Modernization, in order to implement necessary fraud controls, as well as to safeguard the privacy of taxpayer information. In short, we need to modernize to accomplish our mission which is to collect the proper amount of taxes at the least cost; serve the public by continually improving the quality of our products and services; and perform in a manner warranting the highest degree of public confidence in our integrity, efficiency, and fairness. The obsolete state of technology is a major deterrent to effective operation of the IRS today, and it only gets worse if TSM goes unfunded.

VI. Computer Security

Mr. Chairman, you also requested an update on our progress regarding safeguarding taxpayer files from unauthorized access and manipulation. Since your Committee's hearing on this subject in August 1993, there have been numerous meetings and ongoing dialogue between our staffs, in addition to the meetings you and I have had. Our current and planned actions have been shared with the Committee staff and our efforts to date have been favorably received. I have recently appointed Robert Veeder as the Privacy Advocate for the IRS. As a senior policy analyst at OMB, Mr. Veeder has worked extensively with the Privacy Act and Freedom of Information Act. In his new role, he has the responsibility for developing and overseeing an Internal Revenue Service-wide Privacy program.

As with the filing fraud issue we just discussed, the systemic solution to safeguarding taxpayer information is also found in TSM. Without TSM, the Service will not be able to provide state of the art security and privacy protection for taxpayer information. Included as an Appendix to my statement is a status report on all of the actions we have undertaken this past year to enhance privacy and security.

VII. Conclusion

Prevention and deterrence are clearly the keys to refund fraud control. Prosecutions are an important component of our strategy, and the IRS will continue to emphasize enforcement. Our detection and deterrence programs are working but need to be enhanced as we detect new schemes. We will balance our efforts to issue refunds promptly with the need to protect the government's revenues. In some instances, we may choose to delay questionable claims while they are carefully scrutinized and pay interest rather than risk allowing fraudulent refund claims to be accepted.

All of our partners in tax administration need to recognize that fraud reduction is a joint responsibility. We must also recognize that fraud detection may necessitate the slowing down of the refund process. Mr. Chairman, we need your understanding, as well as that of your colleagues, that a further streamlining of the refund process, especially with respect to motor fuels excise tax claims, would seriously jeopardize our efforts to detect and prevent refund fraud.

Mr. Chairman, this concludes my prepared remarks. We would appreciate any suggestions for improvements that you or your colleagues may wish to offer, and my

colleagues and I would be happy to answer any questions you or other Committee members may have.

APPENDIX I

PROGRESS IN IMPROVING IDRS (COMPUTER) SECURITY

Introduction

Mr. Chairman, as you requested in your invitation letter to the hearing, we are providing to you, in this Appendix, an analysis of the progress made by IRS to better safeguard taxpayer files from unauthorized access and manipulation. Since the August 1993 hearing before this Committee, we have taken numerous steps to increase the protection afforded taxpayer information, provide an Advocate for privacy, help prevent privacy abuses in the future, penalize those who commit such abuses, design and develop more efficient information systems to identify such abuses, as well as plan for the development of future TSM systems that will prevent them from occurring at all. We believe that we have made significant progress in all these areas.

Some of the specific actions we have taken include instituting an IRS-wide privacy policy statement and principles, hiring of a Privacy Advocate to review and strengthen our privacy policy, while at the same time helping us establish our own privacy strategy, publishing a penalty guide that covers Integrated Data Retrieval System (IDRS) abuses, upgrading software for detection, and preventing IDRS users from accessing their own accounts.

IDRS Security Issues that Surfaced at the August 1993 Hearing

We have made significant progress in addressing the security issues discussed during the August 1993 hearing. While the misuse of IDRS that we have identified and adjudicated is limited to a small portion of those employees who have access to IDRS (our latest data covering the period since the August hearing indicates that employee misuse of IDRS is approximately .5 percent of all IDRS users—222 management actions for IDRS misuse/56,000 users), we believe that we cannot tolerate even one employee breaching the trust that is placed in us by taxpayers. There are 10 million IDRS transactions a month in each of our service centers, or 1.2 billion transactions a year. Although our efforts this past year establish that the protection of the privacy of taxpayer information is our top priority, we have been and will continue to pursue actively measures to increase the security of taxpayer information to allow us to administer the tax system.

Since the last year's hearing we have completed a review of the 368 potential IDRS security violations our Internal Audit analysis identified in the Southeast Region. Of these 368 cases, 165 resulted in the imposition of some management corrective action including 17 separations, 36 suspensions, 68 reprimands, 26 admonishments, and 18 counseling sessions. The remaining 203 cases did not warrant management action because they were authorized official business.

We also completed a comprehensive on-site review of how these cases were handled to determine whether the dispositions were appropriate. While the results of the review were generally positive, we determined that there were some inconsistencies in imposing disciplinary sanctions in 51 of the cases. We have shared the results of this review with all of our regions and have taken steps to assure that future disciplinary sanctions are consistent and appropriate.

To address inconsistencies in disciplinary sanctions we have implemented a penalty guide to assist IRS management in selecting appropriate sanctions for unauthorized IDRS access and other tax information security issues. In addition, staff from the Office of Ethics conducted case file reviews of a sample of discipline cases from all regions. Based on this review, we issued detailed guidance for all offices on the application of the penalty guide to computer security and taxpayer privacy violations.

While the imposition of appropriate disciplinary sanctions is an important part of ensuring that taxpayer privacy is maintained, we have taken a number of preventive measures to ensure that all of our IDRS users know and understand their responsibility for protecting taxpayer privacy. I sent a memorandum to all service employees emphasizing that security of taxpayer information is one of the most important issues facing the IRS today and that any access of taxpayer information with no business reason is a violation which would result in discipline up to and including removal. We recently completed the development of training for IDRS users that emphasizes the obligation to safeguard the information taxpayers entrust to us and the potential disciplinary sanctions that can be imposed for violating taxpayer privacy.

In addition to the training, we revised our new employee orientation program to include an expanded coverage of IDRS security and the obligation to protect the information taxpayers entrust to us. The messages contained in the orientation session are reinforced by managers in their introduction of the employee to the work place.

Appointment of the New IRS Privacy Advocate

Maintaining the privacy of taxpayer information is crucial to the establishment of a higher level of trust with our customer—the American taxpayer. That higher level of trust is critical to our ability to implement both the tax processing, taxpayer assistance, and compliance systems of the future under Tax Systems Modernization. In order to help the IRS reach that goal I have appointed IRS' first Privacy Advocate, Mr. Robert Veeder. He comes to us from OMB, where he worked extensively with both the Privacy Act and the Freedom of Information Act. In this new role, he is the principal advisor to our Executive Committee, as well as being responsible for our Service-wide Privacy program. He reports directly to the Chief Information Officer and, along with his staff, is primarily responsible for:

- Implementing the IRS Privacy Strategy and ensuring that it is effectively integrated into the development of TSM.
- Acting for taxpayers as their advocate on privacy rights and working to enhance the public's understanding of these rights as they apply to their account information.
- Formulating IRS' position as it relates to, or is impacted by, initiatives proposed by the Congress.
- Developing an on-going privacy training program for all IRS executives, managers, employees and contractors who receive taxpayer information.

Recently, Mr. Chairman, this new office—as part of its Service-wide outreach and training effort—developed a privacy information video featuring you and Senator Pryor that has been distributed to all district, regional, and service center training offices. By the end of the fiscal year it will have been viewed by all IRS employees. In addition, we have distributed a *Protecting Privacy Guidebook* to all IRS Disclosure offices.

Action Plan Progress

After last year's hearing, we developed an Action Plan that covers 35 critical actions aimed at improving both the security and privacy of tax information in the IDRS database. As of July 1, 1994, we have completed 21 of those actions, with nine on schedule and five that have been rescheduled. Some of the major accomplishments of this Action Plan include:

- A Policy Statement on privacy rights issued to all employees which emphasizes the need to protect taxpayers from unnecessary intrusion into their tax records.
- Ten basic privacy principles to establish a public trust for protecting taxpayer privacy and safeguarding the confidentiality of taxpayer information were enumerated. The principles were distributed to all employees and are being discussed in employee group meetings.
- Enhanced procedures for tracking account adjustment activity in IDRS. We are now able to review newly created transcripts and listings to identify high risk activity.
- A review of the IRS Safeguard Review program to ensure it met statutory requirements.
- A Guide for Penalty Determinations that lists penalties for various types of misconduct has now been issued to all employees.
- Installation of the Electronic Audit Research Log (EARL) system in all service centers in March, with five custom search scenarios to perform searches of the IDRS audit trail for security staff and management. An enhanced version of the EARL software now being developed will provide audit trail reviews aimed at detecting browsing of taxpayer records by IRS employees based upon unusual patterns of employee access to taxpayer records. The first two searches to be implemented will identify (1) employees who access the same taxpayer record in multiple calendar years; and (2) selective taxpayer records which may be looked at by many IRS employees.

Future Security Controls That Will Be Provided Through TSM

Peter G. Neumann, a noted international expert on privacy and security who has participated in numerous National Research Council efforts, is a member of my Commissioner's Advisory Group and is the co-chair of the subgroup on technology, security and privacy. Mr. Neumann has looked at our plans for integrating privacy

and security into TSM, and feels that we have charted a sound course of action for ensuring security protection for the future. He urges that we complete the planned activities and not cut back our resources to be applied to this important part of the program.

Tax Systems Modernization will significantly enhance our ability to prevent system abuses by better up front security as well as more rapidly identifying misconduct. Some enhanced TSM systems will include:

- Near real time alarm systems which utilize advanced technologies, such as artificial intelligence software, to alert the system administrator of a potential security violation. The violation will be determined much more quickly than currently occurs. (Review of audit trail records now occurs after the violation is weeks or months old.)
- A security profile that specifies the extent of access to taxpayer information for each user of IRS information systems. All other access to taxpayer data, for which there is no official need to know, will be prevented.
- New workload management techniques that will assign cases to employees based on their current skill levels and security authorizations. These techniques will only allow access to that employee's specific workload, therefore making browsing almost impossible.
- For taxpayers, IRS will begin using authentication and identification techniques such as personal identification numbers (PINs) and Smartcard technology to identify and ensure the authenticity of the taxpayers calling in on touch-tone phones when they request access to their account information.

Conclusion

Mr. Chairman, since last August's hearing the IRS has taken an aggressive stand to demonstrate to our employees, the Congress and most importantly—the American taxpayers—that we are serious about protecting the confidentiality of taxpayer information. Abuses of taxpayers' right to privacy will not be tolerated. We now have a better detection system, a strong penalty guide, an IRS wide privacy policy, an Advocate for privacy, and plans to make our systems of the future much more secure from any employee's abuse. We believe we have made significant progress since last August, but we recognize that ensuring the privacy rights of all taxpayers is a long term process that will require our steadfast vigilance.

PREPARED STATEMENT OF JAMES B. THOMAS, JR.

Mr. Chairman and Members of the Committee:

Thank you for inviting me to share with you the views of the Office of Inspector General on problems associated with fraud and abuse in the Education Department's Federal Family Education Loan (FFEL) program and the lessons that the FFEL program can teach us about how to implement the new Federal Direct Student Loan program.

We are at the beginning of a period of rapid change in Federal lending to students. In the space of just a few years, the Department of Education hopes to complete the transition from a system that has been in place for almost 30 years to an entirely new system of lending. Under the FFEL program, loans have been, and are continuing to be, made to students or their parents by private lending institutions that receive Federal guarantees against default and "special allowance" payments to supplement the interest paid by borrowers. Replacing this system—which involves a host of participants (guaranty agencies, lenders, and secondary markets)—will be a new system under which loan capital is provided by the Federal Government and loans are made directly by the Department of Education. During this transition to direct lending, the two systems will co-exist, with increasingly large loan volumes being processed under the new system.

As is the case in any transition between systems, the potential exists for problems to occur in the transition to direct lending. The reasons for this are the following: the creating of new accounting and delivery systems, the scale of the change (not only considering the amount of Federal funds involved but the numbers of participating schools and students), and the short time-frames for moving to full implementation of the new systems. In addition to the problems with the FFEL program that will carry over to direct lending, there will be problems associated with winding down the old program as well as starting up the new.

In my testimony today, I will cover each of these categories of problems—carryover problems, and those associated with the winding down and starting up of sys-

tems. In discussing these problems, I will focus my attention on the particular topics you have asked me to address——

The current financial condition of the FFEL program;
Losses under the FFEL program and the potential liability to the Federal Government;
Efforts being made to reduce FFEL losses;
Efforts being made to improve information systems and other systems associated with the loan programs; and
The difficulties with starting up the new loan program, including potential internal control weaknesses.

However, before addressing these issues, I would like to clarify the role of our office in the process of this transition. We have not taken the traditional audit approach to review the program after implementation. We have been involved in various aspects of the transition in an independent advisory capacity in the development of the new systems.

Providing an advisory service is substantially different from providing an audit service. Audits are based on substantive testing and include recommendations to correct identified problems and prevent them in the future, whereas advisory services provide insight, based primarily on past experience, to help avoid problems before they become problems. Advisory services are preventive, audits recommend corrective and preventive actions. In either case, however, the ultimate responsibility for accepting and implementing recommendations or advice rests with management.

Lessons Learned From the FFEL Program—Continuing Concerns

Based on our audit and investigative experience in the student loan programs over the past several years, we believe there are lessons that should be kept in focus by the Department and the Congress as the transition to direct lending proceeds. While direct loans will be administered via a new delivery system, they will be managed in an environment that is in many major respects identical to that which has existed for the FFEL program. We remain concerned over several aspects of this environment as the transition to direct lending begins. These include the gatekeeping functions, failure to pay loan refunds, and lack of assurance that vocational training will help in obtaining gainful employment.

Gatekeeping

The suitability of approximately 8,000 public, private, and for profit institutions participating or seeking to participate in direct lending will be determined by the accreditation, State licensure, eligibility, and certification procedures commonly referred to as the "gatekeeping" process. As we have reported and testified to on many previous occasions, this gatekeeping process has proven insufficient in keeping weak and unscrupulous schools out of the Title IV programs. While in 1992 the Congress enacted many provisions aimed at correcting gatekeeping deficiencies and the Department has worked diligently to implement these improvements through regulation, such improvements are yet untested and we are aware of nothing in the design of the direct lending program that will compensate for gatekeeping weaknesses should these improvements prove inadequate. It should be noted here that, because the Department is being very selective in choosing schools for initial Direct Loan program participation, gatekeeping weaknesses might not surface until two or more years out when the remaining schools enter direct lending.

We have been advised of many improvements the Department has implemented or plans to implement to strengthen monitoring of schools after entry to Title IV participation. Efforts to improve institutional monitoring are encouraging. Our experience suggests, however, that, unless weak or unscrupulous schools are screened out by the gatekeeping process, significant harm occurs to the student and the taxpayer before the school can be terminated from program participation. The success of the Direct Loan program will be dependent, in part, on the effectiveness of the gatekeeping process.

Failure to Pay Refunds

A second area of concern relates to failure on the part of institutions participating in the current loan programs to pay loan refunds when students withdraw from school during the periods for which the loans were made. As I testified before a Senate Subcommittee in May of this year, students, at this moment, are being victimized by schools' failure to pay refunds; and when loan defaults result, the taxpayer is victimized as well. By failing to pay loan refunds, schools are keeping money they have not earned for services they have not rendered and, when done intentionally, this amounts to theft of public funds. While it is not possible to accurately quantify

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the magnitude of this problem, it is among the most frequently recognized problems in our reviews of schools, departmental program reviews of schools, and in non-Federal audits of schools required by the Higher Education Act (HEA).

Several amendments to the Higher Education Act enacted in 1992 will help in addressing the refund problem but will not solve it. In my Senate testimony earlier this year I offered several recommendations for changes in statute to help reduce the refund problem. These included requiring schools to report regularly to the Department the status of their refund liabilities, enacting changes to program fraud provisions to counter a recent court decision that weakens the ability to prosecute refund fraud cases, and enacting legislation facilitating our use of asset forfeiture as a means of recovering Federal funds stolen by school owners via their failure to repay loan refunds.

I have also testified concerning a remedy that we believe would significantly affect this situation. It is one that we recommended as part of the 1992 reauthorization of the HEA: the Department should be authorized to obtain personal guarantees for Title IV liabilities from school owners or other appropriate persons as a condition for participating in Title IV programs. Both the House and Senate reauthorization bills contained such a provision. However, the Conference Committee amended the provision to effectively nullify this authority. Section 498(e) (4) of the new law bars the Secretary from imposing personal liability unless the school meets all four of the following conditions: it has been subject to limitation, suspension, or termination action within the last 5 years; it has had recent audit findings that required it to make substantial repayment; it is not financially responsible; and it is not current in submission of required audit reports. It is extremely unlikely that a school would meet all of these conditions, since, long before doing so, it would certainly have been closed and gone into bankruptcy, and its owners taken off with the money.

As with the lessons we have learned concerning weaknesses in the Title IV gatekeeping process, we are aware of nothing presently in the direct lending system that will address the problem of unpaid loan refunds. However, we have been working with the Department to develop methods to identify schools that may not be paying required direct loan refunds.

Usefulness of Vocational Training

A third lesson learned from our reviews of the FFEL program is that the current system of Title IV funding for vocational training affords little assurance that the training provided to students is helping them obtain gainful employment. Reports issued in 1987 and in 1993 noted that individuals were being trained, with a heavy investment of Federal funding, for nonexistent jobs. Our 1993 report pointed out that student aid programs are structured to make funds available to students without regard to labor market needs or to the performance records of schools. We believe that the statutory purpose of preparing students for gainful employment in a recognized occupation could be better accomplished and limited Federal vocational training funds more effectively utilized with a revision to the current funding system.

Under the current method of funding vocational training, a participating school can enroll as many students as possible and disburse as much student financial aid (SFA) funding as is available. Because there are no performance standards for student achievement, there is little incentive for a school to be overly concerned about how many of its students graduate and find jobs. School recruiters can promise glamorous, high-paying careers to prospective students, but graduates often receive much less than was promised.

Many students enroll in vocational training programs, incur significant debts, and then are unable to find work because they have been trained in fields where jobs are unavailable. These students often feel victimized and default on their student loans. They are ineligible for additional aid by virtue of their default and are thereby hindered in their pursuit of other education and career options. Students and taxpayers lose under this system. Our report pointed out that it is time to begin exploring the feasibility of different funding approaches that would maximize the return on the SFA funds invested and provide incentives for schools to do better. It is not unreasonable to expect an adequate return on the billions of dollars in SFA funds invested in vocational training.

Specifically, our 1993 report recommended that labor market needs and the performance of schools in graduating and placing their students be considered in SFA funding for vocational training. We also recommended that the Department take the lead in convening an interagency task force to study different funding approaches for vocational training. We understand that both of these suggestions are under consideration by the Department, but that related legislative proposals will not be forthcoming until 1995.

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PROBLEMS IN THE FFEL PROGRAM

Current Financial Condition of the FFEL Program

The OIG and the General Accounting Office (GAO) recently completed a joint audit of the Federal Family Education Loan program's fiscal year 1993 financial statements. In that report we indicated that, "Due to the limited amount of time between fiscal years 1993 and 1992 audits and the severity of the long standing financial management problems, many of the financial management problems identified during the prior year's audit still exist."

The audit report issued to Congress and the Secretary of Education contained the following conclusions:

- We could not express an opinion on three of the four financial statements because reliable student loan data was not available to reasonably estimate the program's liabilities for loan guarantees and other related line items.
- We were able to express an opinion on the statement of cash flows. This opinion indicated that the Department accounted for and fairly reported actual sources and uses of cash. However, due to internal control weaknesses we could not determine if the Department of Education received or disbursed proper amounts to lenders and guaranty agencies.
- In our opinion, the Department's internal controls were not properly designed and implemented to effectively safeguard assets and assure that there were no material misstatements in the Principal Statements. Specifically, we found that the Department had material weaknesses in internal controls over: 1) estimating costs to be incurred on outstanding guaranteed loans, 2) assuring that billing reports from guaranty agencies and lenders were accurate and reported all default collections and origination fees owed to the Department, and 3) preparing accurate financial statements.

The statement of cash flows indicated that the cash used exceeded cash provided by FFEL operating activities in fiscal year 1993 by $3.4 billion, before consideration of appropriation and Treasury debt activity. The financial statements reported the following significant sources and uses of funds:

- The Department paid guaranty agencies $2.5 billion for default claims and $354 million for claims related to death, disability, and bankruptcy.
- The Department received collections of principal and interest on defaulted loans in the amounts of $658 million and $355 million respectively, which include amounts collected directly by the Department as well as amounts collected by guaranty agencies and the Internal Revenue Service on behalf of the Department.
- The Department paid $1.8 billion in interest subsidies to lenders and collected origination fees from lenders of $510 million. (The Department pays interest subsidies on certain loans while the student remains in school or during authorized grace and deferment periods. Lenders collect origination fees from students and pass them on to the Department.)
- At September 30, 1993, the Department had $5.3 billion in fund balance (cash) with the U.S. Treasury. Cash collected by the Department from guaranty agencies, lenders and students is not sufficient to meet cash payments made by the Department. The shortfall is generally financed through appropriations.
- During fiscal year 1993 the Department received $6.5 billion in appropriations for the FFEL program and returned $1.8 billion, due primarily to re-estimates for credit reform. Additionally, the FFEL program recalculated its subsidy cost on loans issued in 1992 and transferred $124 million in excess subsidy previously received to a special fund receipt account as required by the Credit Reform Act of 1990.

The Department reported liabilities for loan guarantees as of September 30, 1993, of $13.6 billion. This amount is the Department's estimate of the net present value of cash flows that are likely to be paid by the FFEL program on loan guarantees outstanding as of September 30, 1993. As previously stated, we could not determine the reasonableness of this estimate since it was based on data that we found to be unreliable. There is no way of knowing, at this time, the potential misstatement of this liability. The Department expected that $10.4 billion of its liabilities would require future funding from Congress. However, this need for additional funding could be higher or lower depending on actual default claims, payments of interest and special allowance subsidies, and collections.

FFEL Program Losses and Potential Liability to the Government

The Department has indicated that since the inception of the Title IV programs in 1965, that it has paid $57 billion in FFEL program defaults, additional interest and special allowance. These include $4.7 billion for payments in 1993. The current portfolio and thus exposure of guaranteed loans is $69 billion. The Department has estimated future liabilities at present value on this portfolio of $13.6 billion on loans outstanding as of September 30, 1993. As just discussed, we are unable to determine the reasonableness of this estimate because of unreliable data.

We believe that what happens in the future relative to guaranty agencies will affect potential liabilities because guaranty agencies have had a significant role in the administration and oversight of the FFEL programs. This role has included guaranteeing student loans, paying claims and collecting on defaulted loans, as well as monitoring and enforcing school and lender compliance with program requirements. These activities impact losses and potential liabilities of FFEL. In addition, some guaranty agencies have developed financial and/or contractual affiliations with lenders, secondary markets and servicing agents. During the phase-in of the Direct Loan program, the stability of these agencies under the FFEL program will be significantly affected.

As the transition to direct lending proceeds, the Department must ensure that the interests of students and taxpayers under the FFEL program continue to be protected. The gradual reduction in their share of the loan market may conceivably lessen the incentive for these guaranty agencies to continue to perform their FFEL program responsibilities. Thus, the Department may be required to assume more direct responsibility for the administration and oversight of the FFEL program. For example, if guaranty agencies and lenders leave the program precipitously, proper servicing and recordkeeping for the loans they have made and guaranteed may be jeopardized; and student access to FFEL loans may suddenly be severely restricted.

Although the statute has provided a Lender of Last Resort program to address the potential student access problem, the effectiveness of the provision is yet to be tested. Also, the Department's ability to maintain uninterrupted servicing of billions of dollars of FFEL loans will be tested when guaranty agencies, lenders and servicers leave the FFEL program.

With the eventual demise of the existing system of guaranty agencies, lenders and servicers, the Department must try to minimize the risk of loss to students and to taxpayers. Losses to students and taxpayers could occur if a rapid decline in revenues causes a guaranty agency to fail to properly monitor due diligence of lenders in their collection efforts; if a guaranty agency intentionally or inadvertently takes steps to misuse or abuse Department assets and reserve funds which the agency is holding; and/or if a guaranty agency abruptly ceases operation, leaving lenders or schools without critical sources of loans or servicing. If the Department is not able to address these problems promptly, losses could result, with potentially significant liability to the government. This means that the Department is held responsible for maintaining the integrity of the FFEL program loans and for protecting guaranty agency reserve funds and assets, while keeping guaranty agency operating costs down.

Efforts Being Made to Reduce FFEL Program Losses

The Department of Education faces many challenges in addressing its long-standing financial management problems, the most important of which is correcting the numerous data integrity problems. The problems I am discussing today are not ones that lend themselves to "quick fixes" but rather require comprehensive efforts to correct root causes.

Department officials have expressed their commitment to developing better financial management information for the FFEL program and the Federal Direct Student Loan program. A number of corrective actions are underway, including the development of the National Student Loan Data System, the first national database of loan-by-loan information. In addition, the Department is developing its first agency-wide strategic management plan and has initiated efforts to design a system to identify key success measures for major programs and support services.

In the OIG planning process, we have identified several factors that represent potential risk regarding guaranty agencies during the transition to direct lending that may impact program losses. We anticipate using these factors to develop a matrix or profile that can be used to track changes and the impact of those changes on guaranty agencies. We hope that continuous coordination with program officials in the Department and site visits to guaranty agencies will help ensure that appropriate adjustments are made, that the Department has the most current and accurate data available, and that mechanisms are established to provide the Department early warning of emerging problems.

With a reduction in the number of guaranty agencies in the FFEL program, the burden of administering and overseeing FFEL program loans and maintaining the integrity of the FFEL loan portfolio will fall upon the Department. The Department must be prepared to respond to changes occurring as a result of the transition to direct lending.

Efforts to Improve the Information System

In the past, the FFEL program has been plagued by an inadequate information system with unreliable data. The National Student Loan Data System (NSLDS) is the first step in improving the Department's information system by providing a more current, combined, and conveniently queried source of data on the financial aid held by a student. The ability to prescreen aid applicants for prior defaults and loan limits has been one of the primary justifications for NSLDS.

In the initial phase, scheduled to start in September of this year, NSLDS will combine information from all the guaranty agencies, the direct loan servicer, and the Pell Grant programs into one database, updated weekly or monthly. That database will be available for use in prescreening loans, for queries and analysis by the Department for monitoring borrowers and schools, and for tracking loan portfolios.

Currently, guaranty agencies are the primary source of NSLDS data. If, however, with the advent of the Direct Loan program, they experience a future decline in loan activity and revenues, they may have no incentive to institute new or revise old systems to gather and control the data needed for NSLDS. Although the integrity of guaranty agency data has varied widely in the past, there are, currently, no realistic penalties that can be assessed for providing incomplete or inaccurate data. For this reason, the Department has reduced the data accuracy and completeness requirements to "crucial" data elements and will not require cleanup of all historical data.

Nevertheless, if NSLDS is to be useful and worth the expense, every effort must be made to ensure that the data entered is accurate. It is crucial, for example, that the Direct Loan program do everything possible to ensure the capturing of accurate Social Security numbers for borrowers. If an incorrect Social Security number is used, previous defaults or aid may not be discovered, or may be inaccurately attributed.

POTENTIAL PROBLEMS IN THE FEDERAL DIRECT STUDENT LOAN PROGRAM

Difficulties in Starting Up the Federal Direct Student Loan Program

Finally, you have asked me to discuss the difficulties, including the potential internal control weaknesses, associated with starting up the Federal Direct Student Loan program.

No discussion of the Direct Loan program would be complete without a brief summary of the timetable accepted and met by the Department. The Request for Proposal for the direct loan servicing system, amended to reflect changes necessitated by law, was released on August 20, 1993, 10 days after the Act was passed. Proposals were received on September 7, and the contract was awarded on December 21, 1993. Under the terms of the contract, the servicing system had to be operational by June 15, 1994, 6 months later.

If a typical timeframe for the development of a system is 2 years, then it can be said that the direct loan system was developed in one fourth of that time. Unfortunately, given the timeframe of this system design, full testing of the direct loan system could not be accomplished prior to operation on June 15. Thus, the real stress-testing of the system is only just now taking place, during operation, while 104 schools are participating in providing almost a billion dollars of loans under the system. Any software deficiencies will appear in operation; and stabilization of the operational environment will, of necessity, take place during that time.

We participated as advisors in the direct loan system's development and were aware of the time constraints. We were told that many changes would necessarily be deferred to the second year. It is our expectation that the Department will be alert to potential control weaknesses and will act expeditiously. We are chiefly concerned that, in the coming year, the Department may be faced with the monumental task of addressing system errors and deferred changes while at the same time expanding from 5 percent of the loan volume in 1994–95 to the required 40 percent in 1995–96 (a 700 percent increase). Because the direct loan system just became operational on June 15 and the first loans made on July 1, it is not practical at this time to discuss specific control weaknesses.

Statutory Issues

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Before closing, I would like to discuss several statutory issues. We see potential problems in the new Federal Direct PLUS program, in the new unsubsidized loan program, and in the origination of direct loans.

Under the 1992 Amendments to the Higher Education Act and effective July 1, 1993, PLUS loan limits were repealed. The PLUS loan amount is determined by the cost of attendance minus any estimated financial assistance awarded to the student. Although this loan amount determination is identical in the FFEL program, lenders in the FFEL PLUS program, using accepted banking procedures, may require a determination of the borrower's ability to repay a PLUS loan. This debt-to-income ratio, as it is known, is as important as the borrower's credit history, for it is used to predict whether the borrower is able to take on additional debt. The borrower's willingness to pay, as exhibited by his/her credit history, may be thwarted by the assumption of a new debt burden. Based on an examination of a combination of financial factors, therefore, a lender may refuse to make a PLUS loan.

In the Federal Direct PLUS Loan program, the statute provides that the servicer will examine only the credit history of a borrower and, in doing so, may determine that a co-signer is required. However, as I have just discussed, credit history does not necessarily show that the borrower can assume additional debt. Without the ability to determine debt-to-income, the Department may be making substantial PLUS loans to parents who are willing but unable to repay.

Another complication of the Federal Direct PLUS Loan program is that rather than repaying the loan under the standard 10-year repayment plan, parent borrowers may select a graduated or extended repayment plan. If the amount borrowed is over $60,000, payments may be made for up to 30 years. In today's market, a parent may conceivably borrow $100,000 in PLUS loans for one child attending a four-year school. If the parent borrower is 50 years old at the time of the final disbursement, he or she would be 80 years old by the time the debt is repaid. It is conceivable, in this case, that the parent borrower may die before the debt is repaid. It is also conceivable that the parent borrower will retire at age 62 or 65 and may default on the debt because his or her retirement income can not cover the payments.

Another statutory issue that poses a potential problem is the unsubsidized loan program that was authorized under the Student Loan Reform Act of 1993. This program will extend loan availability to a large number of students who, by virtue of family income, do not qualify for subsidized loans. In this respect, the program is similar to the Supplemental Loans for Students (SLS) program. The SLS program, which was recently repealed by Congress, was subject to large-scale abuse by schools as they increased the cost of education to equal the amount of loan funds available without adding or expanding the content of the education program. The SLS program was eventually repealed by Congress. For this reason, we believe the new program should be closely monitored in the coming months and years.

The last statutory issue I would like to bring to your attention has to do with changes made in the Higher Education Amendments of 1992 and in the Student Loan Reform Act of 1993 that have made more Federal aid available to postsecondary education borrowers. Early returns indicate that, nationally, students borrowed $7.8 billion from last October through March of 1994, a 44 percent increase in loan volume over the same period last year. The effect of more available Federal money may be tuition increases. That, in turn, would cause more borrowing on the part of students and parents. With the increase in loan availability and increased educational costs, the new loan programs—particularly the PLUS and the unsubsidized loan programs—appear, at least in the short term, to make college more affordable. However, repayment of these loans may cripple borrowers for years to come. And, as we have seen in the FFEL program, the borrowers' ability to repay their loans has serious, long-term effects on program integrity.

CONCLUSION

Mr. Chairman, this morning I have provided the Committee with my views concerning potential risks associated with the winding down of the Education Department's Federal Family Education Loan program and the start-up of direct lending by the Department. Much of what the Department has accomplished in planning for and managing this transition is cause for optimism, while many aspects of this change remain of concern. I look forward to working closely with the Department and the Congress to accomplish the most efficient and effective transition between these programs.

This concludes my prepared statement, Mr. Chairman. I will be happy to address any questions you or other members have at this time.

PREPARED STATEMENT OF MADELEINE M. KUNIN

Mr. Chairman and Members of the Committee:

I welcome this opportunity to appear before your Committee today, Senator Glenn, on the critical subject of reducing fraud and abuse in the Federal Government.

If we share a common purpose at this hearing, it is to change the future title of this hearing from "High Risks and Emerging Frauds: IRS, Student Loans, and HUD," to "How Three Federal Agencies reduced risks and eliminated fraud." No doubt your Committee and my colleagues at the IRS and HUD join me in this objective.

That is the highest goal of the Clinton administration—to restore the confidence of our citizens in our government. That confidence rests on more than rhetoric; it will only be affirmed by our actions which prove to the students, their families, and our institutions of higher learning that every single taxpayer dollar is wisely spent. We cannot afford to waste a cent to fraud, abuse, confusion, or error.

Let me say at the outset, that we can be very proud of the broad access to higher education that our student loan and grant programs have provided.

Thanks to Congressional leadership over the years, almost 200 million awards have made $300 billion available to students since the inception of the programs. Just this year alone we have seen a 35 percent increase in loan volume, amounting to approximately $24 billion total.

More than half the students and families in this country utilize both subsidized and unsubsidized loans. It is safe to conclude, from that information that without this program, access to higher education, and thereby, a higher income and a better life, as envisioned by the American Dream, would be out of reach for millions of Americans.

Our shared purpose here today, then, is not to weaken the system we have created, but to strengthen it through the two pronged strategy of expanding opportunity and increasing responsibility.

Many Americans dream of furthering their education, but are stopped by the barrier of affordability. The new Clinton initiatives of direct lending and income contingent repayments do much to lower that barrier. At the same time, we must make our expectations of repayment absolutely clear. Again, the Clinton initiatives have launched a new era of accountability and responsibility.

In my eagerness to tell you about the preliminary success of our new programs and strong management ethic at the Department of Education, I do not want to gloss over the depth of our problems.

To totally fix these programs, which have suffered from managerial neglect for many years, will take time.

Only constant vigilance and attention to every detail over a period of several years, will enable us to completely turn around these programs.

But what is important for you to know today, is that we are on track. The turn around is taking place. We have made the investments in people, in technology, in training, and most importantly, in management, which are moving us full speed ahead.

This year we are making the first loans under the new Federal Direct Student Loan program and we are very enthusiastic about this development. Over the past 20 years, the Federal Family Education Loan program (FFELP)—formerly known as the Guaranteed Student Loan program—has become the largest postsecondary loan program and an important tool for assuring access to higher education. The Federal Direct Student Loan program will ensure that loan funds are available for students and simultaneously simplify the system making it easier for students and parents to obtain and repay loans. The Direct Loan program also gives us the opportunity to use the vast experience that we have had with the FFELP and to apply the many lessons that we have garnered from that experience.

The experience we have gained and the lessons we have learned are enabling us to implement the Federal Direct Student Loan program more efficiently, while maintaining its financial integrity, and reducing the potential for fraud and abuse. I have appeared previously before other Congressional committees to convey my confidence in our ability to administer the Direct Loan program. My confidence remains undiminished. I am pleased to inform you that participating schools made the first loans under this program on July 1, as we had scheduled.

LESSONS LEARNED AND APPLIED

Let me now enumerate the ways in which the Direct Loan program benefits from our long experience with administering the FFELP.

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We have learned through administering the FFELP that its structure is overly complex, thereby frustrating participants and presenting opportunities for error, fraud, and abuse. We recognized this complexity and designed the Federal Direct Student Loan program to simplify the loan process for students. The application process is easy. Students have to complete only the "Free Application for Federal Student Aid." No other loan application is required. Under the Direct Loan program, students do not have to complete the separate loan applications that are required under the FFELP as borrowers will only have to deal with one entity—the school—rather than a multitude of lenders. Unlike practice in the FFELP, we will notify students every time a disbursement is reported by schools. This independent notification will serve as an important safeguard in the system and will ensure that students are fully informed about the status of their loans, the total amount credited to their accounts and, over time, their total indebtedness.

We believe that people at all income levels should have an opportunity to further their education and that no student should be discouraged from pursuing any particular career choice because of student loan obligations. For this reason, it is important that borrowers have an array of repayment options from which to choose.

Numerous studies have taught us that the vast majority of defaulters do not repay because they are financially unable to do so. This finding, supported by these studies, led to one of our most exciting changes that will be implemented through direct lending—students will be able to choose the method of repayment that best meets their financial situations. They will have five repayment options to choose from: standard repayment, extended repayment, graduated repayment, income contingent repayment, and alternative repayment. After all, many borrowers have unique financial and personal circumstances that change over time. Some have low incomes at the beginning of their careers and higher incomes later. Some have incomes that start low and remain low. A few have incomes that, because of personal adversities, decrease over time. The variety of repayment options we will offer to borrowers will accommodate any of these individual circumstances and will decrease the possibility that a borrower's repayments cannot be supported by his or her income. For some of these borrowers, default can easily become a reality.

Let me draw your attention to the income contingent loan repayment plan, as we believe that it will greatly reduce the incidence of students defaulting on their loans. Under the income contingent loan repayment option, a borrower will repay a small percentage of his or her income—adjusted for the amount of debt that the borrower has accumulated at the time repayment begins. This will reduce the financial burden of student loan repayment, which will allow borrowers to accept lower-paid employment and reduce the chance of default.

We also know that many defaulters do not repay because they do not know where to send their payments or deferment and forbearance requests, as their loans have changed hands numerous times and they have not always been notified. Under the Direct Loan program, every student will have one comprehensive loan record that will be maintained by the Department. Further, the student will always make payments and submit deferment and forbearance requests to the same entity and will not have to worry about sending payments or information to the wrong address.

In addition to simplifying the loan process for students, the Direct Loan program simplifies the loan process for schools. Under the FFELP, schools often deal with a multitude of lenders and guaranty agencies. Like students, schools will have only one entity with which to deal under the Direct Loan program—this will eliminate time and resources that schools must now to devote to tracking paperwork and checks under the FFELP. We are providing software to schools participating in the Direct Loan program for their use in providing borrower information to us, transmitting student data electronically, and creating loan origination records. Schools that do not wish to assume responsibility for managing promissory notes or for drawing down funds may request that we perform these functions for them. Further, the Secretary will assign schools to more restrictive origination levels if the schools do not demonstrate adequate administrative capability. Several reports have highlighted that, in the past, inconsistent timing of reconciliation between accounts in the FFELP created problems. The software that we provide to schools and our requirement that schools reconcile all loan transactions, cash drawdowns, and disbursements monthly will allow the Department and schools to discover any problems in a timely manner and seek corrective action immediately.

We cannot overemphasize the importance we attach to keeping the Direct Loan program simple. From a management standpoint, simplification enhances accountability and accountability is critical to the success of our efforts to curb fraud and abuse.

Status of Federal Family Education Loan Program

Although the Direct Loan program is getting a great deal of our attention, please do not misunderstand. We are not ignoring the Federal Family Education Loan program. To the contrary, the health of the FFELP remains very important to us. After all, over $65 billion in FFELP loans was outstanding at the end of fiscal year 1993, with nearly 5.8 million loans totaling nearly $17.9 billion being made in that year alone. Since the inception of the program, more than $160 billion has been lent.

We continue to monitor the guaranty agencies and lenders participating in the FFELP to assure that access to loans by students and parents is not jeopardized. So far, two guaranty agencies have stopped guarantying loans. Two other guaranty agencies have indicated that they will stop guarantying loans in the near future. The elimination of these guaranty agencies has not jeopardized loan availability because other agencies have agreed to serve as guarantors in those States in which guaranty agencies have ceased operation. However, Congress has provided the Secretary with the authority to take over the functions of a guaranty agency should it become necessary. As part of the transition strategy, the Department has entered into an agreement with a transition guaranty agency to serve as servicer of guaranty portfolios and as a guaranty agency of last resort. In addition, the Student Loan Marketing Association (Sallie Mae) has entered into an agreement to assume responsibility as lender of last resort. At this point, we are not aware of any loan access problems—resulting from either guaranty agencies or lenders leaving the program—under the FFELP. Indeed, during the first 6 months of fiscal year 1994, 2.6 million loans totaling $7.8 billion were made—an increase of $2.4 billion compared to the first 6 months of the previous year.

As the Committee is aware, on June 30, 1994 the General Accounting Office and the Department's Office of Inspector General issued a joint audit report of the FFELP's financial statements for fiscal years 1992 and 1993. While this report identified significant issues related to determining program costs, effectively monitoring payments to guaranty agencies and lenders, and ensuring accurate financial reporting, it also recognized the progress that we have made in our efforts to address these issues.

We have a number of specific corrective actions underway to address issues identified in the report. These include:

- developing guaranty agency and lender audit guides that will focus on the reasonableness of the claims for payment submitted to the Department;
- developing program subsidiary ledgers to support the Department's general ledger; and
- completing the development of the National Student Loan Data System, the first national database of loan-by-loan information on over 40 million loans awarded to borrowers.

In addition, we are hiring new qualified financial management staff and other personnel with appropriate experience who are committed to addressing these and other financial management problems that have plagued our student financial assistance programs for too long.

Improvements Affecting All Student Aid Programs

It is important to note that all of our student aid programs, including the loan programs, will benefit from changes in our gatekeeping and other management procedures.

In the past, some institutions of higher education were allowed to participate in Federal student financial assistance programs that never should have received approval to participate. To ensure that this would not recur, Congress and the Department worked together during the reauthorization of the Higher Education Act in 1992 to tighten gatekeeping controls for participation in the Title IV student aid programs. The 1992 Amendments strengthened institutional eligibility and certification requirements, improved the standards for school accreditation, tightened institutional reviews, and enhanced the State role in licensing and reviewing postsecondary institutions. In addition to these steps, we have undertaken our own initiatives for improving our gatekeeping functions.

Thanks to the 1992 reauthorization of the Higher Education Act, newly applying schools now go through a probationary period, under provisional certification, after which they may apply for full participation in the Title IV programs. This probationary period allows us to conduct a full review of the institution prior to granting it final approval to participate. Since this process began in January 1993, 362 schools have received provisional certification. Currently, all of these institutions are meeting the terms of the provisional certification.

To more effectively identify potential problems at institutions, we evaluate our systems data with high-risk indicators, or indicators that show when a school might be having trouble administering Federal aid funds. Also, we have tightened our on-site institutional review process by focusing reviews on expenditure related aspects of the programs—in other words, we now follow the dollars. This focusing has allowed us to reduce duplication, restructure review procedures, and streamline the way in which institutional reviews are conducted. We now perform two types of program reviews: a survey review and a concentrated team review. The survey review is similar to the traditional program review where one or two reviewers arrive at a school to conduct a review. If these reviewers find early-warning signs of what seem to be serious problems, they can call for a concentrated team review by requesting that our Institutional Participation and Oversight Service send additional reviewers with specific areas of expertise. A concentrated team is then dispatched to review the school.

Another feature of our new review process is the use of statistically valid sampling, which allows reviewers to use a mathematical methodology to assess liabilities accurately across any Title IV portfolio. We will use statistically valid sampling on all concentrated team reviews and valid judgmental samples on survey reviews. We have established more highly specialized statistical sampling teams in headquarters to assist all regional institutional and program reviewers in designing the appropriate sample. The sampling benefits both institutions and the Department as it makes the review process fairer to institutions and makes it easier for us to substantiate our findings.

We have created new school audit resolution procedures. These procedures have enabled us to reduce the backlog of audits to be resolved by the Department from approximately 780 to 25. Further, we have begun to take prompt adverse actions against schools that fail to submit audits when they are due.

In addition to improving the quality of our institutional reviews, we are increasing the quantity. Since fiscal year 1989, we have conducted an average of 682 institutional reviews per year. We are projecting a record 2,000 reviews for fiscal year 1996. This improved and expanded review activity has been made possible by the streamlined review process, new institutional reviewers we have been recently authorized to hire, and new computer applications. For years, institutional reviews have been hampered by a hiring ceiling that allowed for only 113–117 institutional reviewers nationwide. As of fiscal year 1994, this ceiling has been raised from 117 to 172 FTE. All of these positions have been filled and all new reviewers are commencing a 23-week training program starting on July 25. These new hires include individuals with legal backgrounds and with business administration degrees, as well as certified public accountants, experienced investigators, and former school financial aid administrators. I would note that many of our new reviewers were hired through the Outstanding Scholars program. In our newly established training academy, we will train these new hires, as well as those reviewers whose skills need upgrading. Also in the academy, we will train many of our headquarters staff on new computer software, applications, and program enhancements.

All of our regional program reviewers are now equipped with notebook computers and specific program applications, such as institutional profiles, standard paragraphs, and review spreadsheets. Additionally, all systems are loaded with word search reference libraries, including the student aid handbook, bluebook, all regulations, Dear Colleague letters, and more. The reviewers' on-line systems will be linked with Internet to enhance the reviewers' information gathering capability and allow reviewers to link with all of the institutions that use the Internet.

We have tightened considerably post-review procedures as well. Upon the conclusion of an institutional review, a school is no longer able to postpone Departmental action on negative findings by requesting administrative extensions—this was a frequent occurrence in the past. Now a school has no more than 30 days to provide requested material or its own supplemental information. If the school does not respond within this time frame, we will consider placing the school on a reimbursement payment system. This means that the institution cannot draw down funds directly—all requests must be justified. Then, unless we receive information within a specified amount of time that will change a finding, we will take appropriate action against the school to restrict or stop its access to Title IV funds.

We recently published final regulations governing the Secretary's recognition of accrediting agencies. These regulations provide us with another valuable tool to use in preventing and detecting fraud and abuse. Accrediting agencies must now have standards for evaluating schools that address a number of areas, including fiscal and administrative capacity, program length, tuition and fees, refund practices, default rates, and success with respect to student achievement. If an institution or program fails to meet an agency standard, the agency must determine an appro-

priate time frame in which the institution or program must take corrective action to comply.

Also, we have established the 15 member National Advisory Committee on Institutional Quality and Integrity. The members appointed bring exceptional experience and knowledge to this endeavor and they will be immensely helpful to us in our efforts. The Committee held its first meeting last month.

In addition to the institutional reviews that we conduct and the enhanced requirements placed on accrediting agencies, as a result of the 1992 Amendments, States are now much more involved in ensuring that institutions are not abusing the Title IV programs. If in the course of the annual review of an institution, the institution sets off any of the statutory "triggers" (such as a cohort default rate equal to or greater than 25 percent or a citation by the Secretary for failure to submit audits required in a timely fashion), the Department will refer the institution to its State Postsecondary Review Entity, or SPRE. The SPRE will then review the institution and can recommend terminating the institution's Title IV eligibility if the school does not meet the SPRE's standards.

The application form for 1994 funds under the State Postsecondary Review program was just recently approved and SPREs can now apply for these funds. As soon as a SPRE's plan for spending the 1994 funds and its standards have been approved by the Secretary, the SPRE can begin conducting reviews of referred institutions. We expect the first standards to be approved by the Secretary next month.

Our previous experience with the FFELP has taught us that the quality and timely availability of student loan data is extremely important to help prevent fraudulent and abusive actions by unscrupulous and unprincipled individuals. The National Student Loan Data System (NSLDS) will help alleviate many of the data problems we have had in the past. The NSLDS will make more current data available from institutions and can be used to screen borrowers, thereby preventing those who have defaulted on loans or reached maximum award levels from receiving additional loans. We plan to implement the first phase of the National Student Loan Data System in September 1994. When the NSLDS is fully operational, we expect to save $300 million per year by preventing inappropriate awards from being made. In fact, we are already realizing some of these savings through our interim efforts to match student financial aid applicants to defaulters on the annual tape extract.

Let me take a moment to explain how we will use the NSLDS to screen applicants. The NSLDS will report all of the available data regarding a student's Title IV aid history. These data will include the status of prior aid received, the total amount of aid received, and any loans received. This report alerts financial aid administrators to students who should not receive additional Title IV aid because they have met the aggregate limits on loans, are in default on existing loans, or owe grant overpayments.

We are undertaking a number of measures to ensure the quality and accuracy of the data initially loaded into NSLDS and to improve the data quality long-term—these measures include a number of design edits in the software to prevent inaccurate information from being entered into the system.

Further, the Department's contractor is writing data verification and formatting software that will be run at data providers' sites to ensure the quality of their data submissions.

CONCLUSION

In conclusion, we are pleased with the improvements that have been made in the management of the loan programs and our gatekeeping activity. Again, I want to thank the Committee for their support in these efforts. Finally, I would like to note that we are facing many challenges to the new regulations that have been published. We are vigorously defending these regulations and will certainly apprise you of any significant adverse court rulings or other developments that might warrant Congressional action. I know that we can count on your continued support in our efforts to strengthen the integrity of our student loan programs.

I would be happy to answer any questions that you might have at this time.

PREPARED STATEMENT OF SUSAN GAFFNEY

Mr. Chairman, and Members of the Committee, we are pleased to be here today to participate in the discussion of "high risks and emerging fraud in government programs." The Department of Housing and Urban Development unfortunately has had its share of scandals over the years. Many people argue that HUD programs are inherently vulnerable to abuse and I think our discussion this morning falls in

line with that argument. HUD's multifamily insured housing programs are indeed high risk. Potential losses are enormous and historically HUD has not effectively deterred the abuse.

One major problem in HUD's multifamily insured housing programs is the issue of equity skimming. In our testimony today, we want to give the Committee our Office's perspective on equity skimming; what it means in terms of HUD losses and tenant living conditions, why it happens; why it is difficult to stop; what steps the Department is now trying to take and what Congress might do to help.

BACKGROUND

FHA Insurance

The Federal Housing Administration (FHA) has long been a dominant source of mortgage insurance for multifamily mortgages, particularly for projects providing housing for low and moderate income families. Basically, FHA assures a lender that it will pay substantially all the outstanding indebtedness in the event of default by the borrower. When that happens, the mortgage is assigned to FHA and the borrower pays FHA its monthly payments. If the borrower continues in a non paying status, the next step is foreclosure where FHA becomes the owner and manager of the project and ultimately attempts to sell the project to a new owner. The assignment, foreclosure, and sale process is a very long and usually very costly one for FHA. For the multifamily programs, the losses to the insurance funds are much larger than the premiums collected. Thus, appropriations are needed to cover the losses. With that very basic sketch of the insurance process, we would now like to present some statistical data to put FHA's multifamily risk exposure in perspective.

—Last fiscal year, FHA paid over $965 million of insurance claims.
—At September 30, 1993, FHA had about $43.9 billion of insurance in force and had established loss reserves of about $10.5 billion to cover potential future losses on that insurance.
—At September 30, 1993, FHA held loans, on which claims were previously paid, amounting to about $7.8 billion, and $6 billion of that amount, or 80 percent was nonperforming.
—At September 30, 1993, FHA held foreclosed properties for sale of about $823 million and realized losses on the sale of foreclosed properties during the year of about $357 million.

Mr. Chairman, you can gauge from these numbers that FHA indeed has a great deal of risk exposure and has absorbed and will continue to absorb losses in the billions of dollars.

Equity Skimming: Its Implications and Its Scope

Equity skimming plays a significant part in the realization of losses to the FHA insurance funds. The formal definition of equity skimming can be found in 12 USC 1715z–19 which is a HUD-specific criminal statute. Equity skimming is the willful use of any part of the rents, assets, proceeds, income or other funds derived from the property covered by the mortgage during a period when the mortgage note is in default or the project is in a nonsurplus cash position as defined by the Regulatory Agreement covering such property, for any purpose other than to meet actual or necessary expenses. The statute provides for imprisonment of not more than 5 years, fines of not more than $250,000, or both.

Also, 12 USC 1715z–4a provides for a civil remedy and establishes procedures permitting the government to recover double the value of any assets or income of a HUD insured project that the court determines to have been used in violation of the Regulatory Agreement or any applicable regulation. In addition, the government can recover all costs relating to its lawsuit for such damages, including reasonable attorney and auditing fees.

On their face, these statutory tools provide HUD with the potential ability to mitigate losses and hold project owners and managers accountable for their fraudulent behavior. Unfortunately, the tools have not proved all that useful in stopping equity skimming in the past. Much more can and should be done in this arena. We will discuss later the current efforts to improve enforcement performance.

Apart from the fairly obvious financial losses that HUD incurs when owners collect rents but do not pay the mortgage, equity skimming generally has other insidious implications. Most notably, living conditions deteriorate for the tenants as funds intended to maintain, replace, or repair living units are diverted for the personal use of owners. Low income families are often trapped in these conditions because their HUD supplied rent subsidies are tied to the units.

There are strong indications that most project owners maintain their projects in an effective, efficient, and economical manner. About 96 percent of all the mortgage insurance in force covers projects that are current in their mortgage payments.

Nonetheless, evidence also exists that the equity skimming problems have been long-standing and pervasive. Many owners intentionally misuse the multifamily programs for personal gain. For example, in the past 3 years, our Office conducted audits of 37 projects (a minuscule percentage of the insured portfolio) with indicators of equity skimming. Those audits disclosed, and HUD management agreed, that over $22 million had been diverted from the projects illegally. Despite the documented findings, HUD was able to recover only $4.7 million (about 20 percent) of that amount from the project owners. The vast majority of the recoveries went back into the projects from which the money was taken, not to the Federal Government.

Causes of Equity Skimming

The reasons some owners violate HUD requirements and divert project funds are multi-faceted. The reasons range from simple greed to more complex issues associated with the structure of the programs and myriad tax laws and consequences. The bottom line remains, however, that when an owner chooses to misuse project funds, it is almost always with the idea of personal enrichment and with little worry that, if and when caught, he or she will have to pay any meaningful consequences.

Typically, the borrower on a HUD insured mortgage is a single purpose entity that was organized solely for the purpose of owning the project. The insured mortgage is nonrecourse debt, meaning the individual owners can not be held personally responsible in the event of default. Moreover, the design of HUD's multifamily mortgage insurance programs often requires only a minimal equity investment (10 percent), and that investment usually consists of noncash items, such as fees and profit allowances earned during construction of the project. In the case of programs for refinancing existing projects, owners are allowed to withdraw their invested equity as part of the new mortgage proceeds. So, with little vested interest, owners often have more to gain by diverting project funds than they would by using the funds for continued project operations.

Enforcement Actions

Once an owner gets into the "nothing to lose" position with a project, HUD must be able to promptly identify project abuse and take the steps needed.to minimize the impact on the tenants and the insurance funds. HUD has not been able to respond in this manner. HUD Field Offices do not have the resources and systems to adequately assess troubled projects and take effective loss mitigation actions.

Even when detected, enforcement obstacles exist. Typically HUD's hands are tied because effective enforcement actions trigger other events that are not in HUD's interest, such as:

a. If HUD declares a default of an insured mortgage, this results in acceleration of the debt by the mortgagee, the payment of a claim from the FHA insurance fund, and a lengthy and expensive disposition process.
b. If HUD defaults a Section 8 contract or other subsidy contract, this results in a recapture and rescission of the contract authority. However, the subsidized tenants are then left without affordable housing.
c. If HUD abates the Section 8 payments on a significant number of units in an insured project, the cash flows decrease, the owner cannot pay the mortgage or repair the units, the residents continue to live in unacceptable housing, and HUD pays a claim from the insurance fund.
d. If HUD decides, as a last resort, to foreclose on a project because the owner refuses to take needed corrective actions, the owner may quickly hide behind Bankruptcy Act protections to delay HUD action, thus causing more costs and deteriorated units.

Other tools employed by HUD may also exacerbate the problems that exist or fail to provide a cure. For instance, actions such as decreasing the number of Section 8 units or denying rent increases ultimately tend to hurt low income tenants—not the project owner whose personal financial status remains unchanged.

All of these concerns, coupled with the staff intensive and lengthy processes involved in taking action, have contributed to a culture at HUD that results basically in a wholesale disregard for available enforcement tools. Consequently, equity skimming and other Regulatory Agreement violations go virtually unchecked.

Enforcement of Equity Skimming Statutes

As mentioned earlier, criminal and civil statutes offer a potent and effective tool in controlling or deterring the extent of equity skimming. However, past efforts to use these tools have proven time consuming and difficult. Recently, both criminal

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and civil actions were brought against an owner in Kansas City. This case both demonstrates the impact of fraudulent equity skimming and illustrates the time consuming nature of pursuing enforcement actions.

The Rosedale Ridge project, located in Kansas City, is a 161 unit complex which was insured under HUD's section 236 program. Eighty one units received Section 8 assistance. Mortgage interest rate reductions and rent subsidies approximated $343,000 per year. The owners purchased the project in 1986.

In August 1989, at the request of HUD managers, OIG audited the project and disclosed numerous equity skimming violations including:

Failure to maintain the Reserve for Replacement	$ 79,256
Diversion of Project Assets	282,965
Diversion of Tenant Security Deposits	34,502
Unsupported Expenditures	357,095
Improper Purchase of Equipment	17,337
Receipt of Unauthorized Management Fees	27,913
Total	$799,068

During the audit, we found that most apartment units contained serious tenant health and safety hazards, including roach infestation, falling ceilings and windows, and doors that did not provide security or protection from the weather. The estimated rehabilitation at the project was $1.4 million. Many of the families at this project did not have the luxury of being able to move to another apartment of their choice because they relied on the HUD unit-based subsidies to help make their rent payments.

The mortgage went into default and was assigned to HUD in October 1990. HUD paid a mortgage insurance claim of $1.8 million and the project was foreclosed in February 1992. The project was subsequently sold at a loss of $1.4 million. To maintain the low income character of the project, HUD agreed to provide Section 8 subsidies for all the units in the project with a contract that will cost HUD $10.7 million over a 15 year term. Additional costs to the government include Low Income Housing Tax Credits worth about $710,000. Thus the total cost to the Federal Government, in this case of equity skimming, is staggering indeed.

Based on the results of this audit, we referred the irregularities for investigative action, and later performed an audit of six other projects owned by parties related to the owner of Rosedale Ridge. These audits showed similar patterns of abuse. The owners were looting the projects, and tenants were forced to live in deplorable living conditions. We identified about $1.1 million in additional equity skimming at those projects. HUD paid insurance claims in excess of $7.7 million on four of these six projects.

OIG and FBI special agents investigated this case on a comprehensive basis for about 2 years. These efforts culminated in October 1993, when four of the project principals plead guilty. One of the owners began a prison term in July 1994, and the other three individuals are awaiting sentencing. In addition, based on the guilty pleas, a civil fraud case was brought against the owners and in December 1993, a $1.6 million double damages judgment was awarded to the government on the Rosedale Ridge project. Additional civil actions are being pursued on the other projects.

These Kansas City cases represent perhaps the most successful prosecutive efforts we have ever experienced in the equity skimming arena. However, some might argue that the time and effort expended on those cases was hardly worth it. We believe the potential deterrent value of successful criminal and civil prosecutions is unlimited, and we are committed to finding better and faster ways for using those statutory tools.

Operation Safe Home

Last December, in consultation with Secretary Cisneros and his top staff, our Office devised a strategy to tackle crime and fraud in a more proactive and coordinated fashion. After numerous meetings within the Department and with other law enforcement agencies, these plans and strategy culminated in an announcement on February 4, 1994, of OPERATION SAFE HOME. Vice President Gore, Attorney General Reno, Secretary Bentsen, Secretary Cisneros and Dr. Brown participated in this joint announcement at the White House. OPERATION SAFE HOME is a new anti-crime initiative designed to combat violent crime and fraud at public and publicly assisted housing. It is a three-pronged attack that focuses on: 1) violent crime at public and assisted housing complexes, 2) white collar crime at public housing agencies, and 3) equity skimming at multifamily insured projects. The operation is a concerted effort to assure better coordination and more creativity by all law enforcement agencies in addressing mutual concerns. In other words, we hope to make

smarter use of the limited Federal resources by leveraging any and all available resources.

In the equity skimming arenas the strategy is rather straight forward and simple. We want to develop strategies to obtain successful criminal and civil prosecutions, and, thereby, send the message that equity skimming will no longer be tolerated. Our Office in coordination with the HUD Offices of Housing and General Counsel has taken a proactive approach in identifying cases to prosecute on a criminal and/or civil basis.

Our staff has worked closely with the Department of Justice in this regard. We have been in contact with all 94 United States Attorneys and have participated in conferences with Civil Assistant United States Attorneys from around the country. The overall intent of this extensive outreach is to solicit DOJ's assistance in applying the criminal and civil statutes.

These efforts are beginning to produce results. Where in previous years our Office might have only a handful of equity skimming cases in inventory, a statistical profile reflecting these more proactive efforts as of last week follows:

	Number	Estimated Skimming
Total Cases identified	117	$ 92,630,000
Settled by HUD	8	13,767,000
Court Judgments	2	2,190,000
Cases Presented to USA	170	62,565,000
Accepted Criminal	11	6,843,000
Accepted Civil	31	32,354,000
Accepted Both	10	14,813,000
Under Consideration	18	8,555,000

We are extremely pleased with the cooperation we are receiving from the Department of Justice and from other Federal law enforcement agencies as we move forward with OPERATION SAFE HOME. We are hopeful that with continued support, significant inroads can be made in deterring equity skimming.

Additional Measures Needed

While we are convinced that criminal and civil fraud prosecutions will have a significant effect on equity skimming over time, HUD managers should not rely on those prosecutions as their main enforcement weapon. Much more needs to be done in the area of program enforcement.

The Office of Multifamily Housing, under the leadership of Nic Retsinas and Helen Dunlap, has embarked on an effort to change the program enforcement culture at HUD. A task force, consisting of Headquarters and Field Office staff, has been analyzing current tools and developing possible ways to improve performance in this regard. We certainly applaud these efforts and are supporting the task force in several significant ways.

As we have pointed out in several of our most recent Semiannual Reports to the Congress, HUD has three systemic weaknesses that affect almost every thing HUD does. More specifically, HUD lacks needed human resources, its data systems are outdated and unreliable, and its management control environment needs major improvements. These weaknesses significantly impact Multifamily Housing operations and especially enforcement activities. Effective enforcement actions are time and data intensive. Without' adequate staff and timely data, HUD is severely limited in what it can do to detect problems, and then take the appropriate corrective actions. The enforcement task force is attempting to develop some short term measures that can work despite the staff and system weaknesses. In addition, the task force is identifying new or improved enforcement tools, some of which will require Congressional action.

Legislation has been proposed and is contained in bills that are scheduled to go to the floor in both the Senate and the House. There are provisions to improve the equity skimming statutes, to expand civil money penalty provisions, and to allow recapture of Section 8 subsidies that now would be lost, if enforcement actions are imposed on owners. We fully support these legislative proposals and urge Congress to act on those measures.

We also strongly support current attempts being made by HUD and others to modify the Bankruptcy Code and provide HUD with an ability to foreclose on defaulted properties in a more timely and less costly manner. In addition, we believe that HUD should consider some other longer term changes to the structure of the

multifamily programs that could significantly change the owners' current incentives to engage in equity skimming. Such changes would include issues dealing with cash equity investments, recourse debt provisions and tax law changes.

In summary, Mr. Chairman, we are convinced that HUD's multifamily programs have enormous risk exposure and have experienced significant amounts of fraud. We hope this hearing will focus attention on the need to move forward aggressively, on several fronts, to assure that HUD losses are minimized to the extent possible. Thank you, and we will be happy to answer any questions you may have.

PREPARED STATEMENT OF NICOLAS P. RETSINAS

Mr. Chairman and Members of the Committee:

Thank you for allowing me to come here today to discuss with you the Department of Housing and Urban Development's concerns and efforts in preventing fraud in our multifamily insurance and assistance programs. I know the topic of this committee's hearing today is the much larger issue of fraud in Federal programs and HUD's potential exposure to fraud is only part of the issue. I am not here to rehash the department's past problems with fraud and abuse. As many of you know, we have been working diligently to correct the past problems. However, more needs to be done. The work is far from finished. The multifamily housing portfolio is large and complex, particularly the assisted housing portion. HUD does not act alone in this arena. The Federal tax code, State and local laws, and the financial markets all play a role, directly or indirectly, in the operation of the multifamily stock. I want to take this opportunity here today to review the scope of our current problems, tell you what we're doing to solve those problems, and what additional tools we need from you and your colleagues on this committee and our authorizing committee to make HUD's fight against fraud even more effective.

In your request that I come before you today, you said that you wanted to discuss equity skimming. It is a technical term with a specific definition. Equity skimming is a payment to or on behalf of a lower priority creditor (or equity holder), such as the owner or an owner's affiliate, made at the expense of a more senior lienholder, in this case HUD. This frequently occurs when the project is troubled, either in default or in a non surplus cash position. The term can also include distributions to owners in excess of surplus cash or in excess of a limited distribution amount to which the owner had agreed. It can also include excessive or unnecessary fees or expenses charged to a project typically by an affiliate of the owner.

However, that term is really shorthand for a number of schemes we have uncovered which divert project funds from their intended use to the pockets of owners and management agents. Why are we so concerned about diversions of funds? When owners improperly pay themselves or pay out project funds for goods and services not received or illegitimate project expenses, the monies available to provide for the needs of the project and its residents are diminished. Since most federally assisted projects operate at the margin, any such illegal or inappropriate expenditure can contribute to a default under the mortgage which can result in a claim paid by HUD. Diversion is a reprehensible act, robbing low income tenants in our multifamily housing of the financial resources necessary to operate the housing successfully, and robbing the American taxpayer of tax dollars. While it is easy to condemn the diversion of project funds, it is more difficult to identify where losses are occurring or why they occur.

My colleague, Susan Gaffney, the Inspector General for HUD, has already outlined some of her findings and some of the background. She has provided you with some of the reasons why equity skimming or diversion of funds can take place. I would like to discuss what the FHA is trying to do to curb abuses and to remove the opportunity for equity skimming. We know we do not have all the answers. We hope we are asking the right questions. We are working hard to come up with the right solutions. And we need your cooperation in providing us with the tools we need to be successful.

Efforts Underway to Identify Problems and Recover Funds

Equity skimming is a pejorative term and I do not want to give this committee the impression that all owners and managers of HUD multifamily projects engage in illegal activities or that all financial transactions by owners and managers are improper or unwarranted. The private owners and managers of insured and assisted properties are business people and are expected to receive income from their investment. We have to distinguish the proper conduct of a business from improper conduct. We also have to remember that our multifamily projects sometimes fail or have maintenance problems for reasons which have nothing to do with the financial

activities of the owners and managers. We also know that the condition of the properties does not necessarily relate to the presence of diversion of funds. Perfectly maintained properties can be victimized by improper diversions; and properties with severe maintenance problems can have no improper diversions at all. Our efforts to combat improper diversions of funds here are aimed at those few who, through their actions, discredit the many owners add managers who are trying to run good businesses.

We have taken a series of steps which individually and combined should help us to more quickly identify potential diversions of funds. Our goal is to prevent diversions from happening in the first place. Failing that, we intend to do all that we can to recover the monies and put them to the use intended.

Confronting the problems of equity skimming, improper diversions of funds and inappropriate expenditures requires different kinds of action. First, we must have mechanisms in place which allow HUD to detect this behavior. Second, once detected we must have the ability to conduct an intensive investigation. Third, we must take aggressive enforcement action to correct the problem and prevent further wrongdoing. Lastly, we must redesign certain features of our programs which will act as deterrents or disincentives for owners to divert funds.

However, I must emphasize at the outset, and I cannot emphasize this too strongly, we can put into motion any number of warning systems, contracts and analytical mechanisms into place, but without the staffing complement to examine evidence, conduct the intensive, often on site, investigations necessary to establish that a violation has occurred, those systems are virtually an empty threat. Without the internal resources which give the Department the ability to act and act swiftly, all the detection systems in the world will not act as effective deterrents against this kind of behavior.

I can and have contracted for the detection systems, but I do not have the labor force necessary to convince owners that those who divert funds will be caught and prosecuted. Owners who know that we do not have the resources will steal with impunity. I need your help in sending them the strongest possible message: the American taxpayer cannot and will not stand for this any longer.

First Goal—Prevention

HUD has a number of systems in place which can and do help us spot problems early and take steps to prevent them from growing. Some of our procedures have been in place for a long time and some are new, responding to current needs and technology. We have always had, as part of the mortgages and housing assistance contracts, regulatory agreements which spell out the requirements for sound management, financial and physical, for the project. These regulatory agreements are the basis for many of our enforcement actions. But they also serve to clearly delineate the rules of performance and I would characterize that as a preventative measure.

I would like to tell you about some of our other procedures: the previous participation clearance, the annual financial statement analysis contract, our coinsured asset management contract, and the owner advancement policy. In addition, I want to stress that a well trained staff of sufficient number is one of the best and, ultimately, cost effective ways of preventing abuse in our programs. Combined, these procedures and the staff to implement them can serve to prevent diversions by detecting them early, and as a deterrent to owners and management agents contemplating diversions.

Previous Participation Clearance—2530 Clearance

don't want to give the impression that HUD and FHA are new to the business of preventing abuses. We have always required owners and other participants in our programs to submit information on their previous participation in HUD programs. The 2530 clearance, as we call it, has proven to be a useful tool in screening potential participants for their past problems. It has also served as a deterrent because owners, builders, managers planning to use HUD programs know they will have to complete this clearance and it will be checked. However, the 2530 clearance is limited to those who have previously participated in HUD programs. It does not reach those who have never participated in HUD programs and, therefore, have no record with us.

In addition to checking potential repeat participants when they apply for a mortgage or loan, we have an additional tool, the limited denial of participation, for individuals and companies who have been determined to have been involved in some wrongdoing. This denial of participation can be for a specific length of time. For more serious offenses, HUD can permanently prohibit, or debar, a person or company from involvement in any HUD programs. Debarment and limited denial of par-

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ticipation only reaches those currently involved in our programs, so these techniques, while important, are limited.

Annual Financial Statement Contract

To help us identify diversions more quickly and to give us a better picture of the financial status of our multifamily projects, we have let a contract to systematically collect, automate and analyze the annual financial statement for each multifamily housing project. Under this contract, all of the annual financial statements of insured or HUD held multifamily projects eventually will be entered into a database. We will then be able to more quickly and efficiently identify problem projects and track the flow of money through the project. The contractors are currently entering the last 3 years financial statements. They have already entered over 65 percent of the 1993 data and are beginning to review and analyze the information. We expect them to be able to do reviews on 30 percent of the project statements, including all projects in the District of Columbia and Los Angeles, this year, another 30 percent next year and so on until all projects have been reviewed and the analyses completed. The contractors will be training field staff in financial statement analysis with particular emphasis on the identification of diversions and improper expenditures.

Formerly Coinsured Asset Management Contract—Ervin and Associates

The formerly coinsured portfolio is, perhaps, one of our most troubled and difficult. With coinsurance, the lender was expected to handle the asset management and properties were never intended to come into the HUD workload. When the program collapsed and Ginnie Mae (GNMA) exercised its rights to assign the mortgages to HUD, that set up a channel for these properties to enter HUD's workload. We had neither the staff or the resources to absorb this work. As a result, in September 1990, we contracted for asset management support services for field and headquarters staff. That contract was reissued in August 1993 for a base year and 4 option years, the first of which we will exercise this August.

The Ervin and Associates coinsurance asset management contract has improved HUD's abilities to spot and recover diversions. This contractor has collected ever $40 million in excess cash that was being held improperly by owners. Ervin and Associates has also identified many equity skimming and unauthorized distributions. We are currently pursuing civil and criminal actions against the violators, as part of Operation Safe Home. The key to this success has been consistent and aggressive followup with owners. Since the contract identifies fraud and abuse on a national, portfolio basis it enables us to identify similar problems that may exist in an owner's portfolio, regardless of location. This coordinated action against such owners on a portfolio basis forces the owners to recognize that they have more at risk than a single bad project.

Owner Advances

The Department is also seriously considering a major revision to its policy on recovering capital advances made by partnerships to address serious or emergency needs not met by normal planning and funding mechanisms. Currently, an owner who advances capital may not recover it until the project is in a surplus cash position. Some of the most troubled projects which require large capital advances may never be in a surplus cash position. This in turn provides a negative incentive to owners otherwise willing to contribute cash to solve a project's financial or physical problems—those projects where the capital is most needed. If an owner recovers capital advances before the project is in a surplus cash position, the Department considers that a diversion, subject to our formidable arsenal of enforcement tools.

This blind mechanism actually discourages exactly what we want owners to do: infuse new capital into projects when it's needed. To obtain infusions of capital we must create a policy which allows owners to recover it over time, perhaps with interest, as a recognizable cost of doing business—whether or not the project is in a surplus cash position. Encouraging rather than tacitly discouraging capital advances should help us prevent the kinds of incidents we have all seen on the A&E Network and will redirect our enforcement efforts toward bona fide fraud and inattentive owners.

Supporting HUD Staff

A well trained staff who understand the job and its importance is one of the best investments we as a department can make. We are taking steps to improve the staff complement and skills. We are augmenting our existing staff with long term temporary employees and we anticipate increasing the number of permanent positions in the field offices. We will be hiring more than 80 people in our field offices specifically to increase the resources available for our asset management efforts.

A major initiative is the Housing Technician Training program. Under this effort, 57 Housing Technicians recently completed the final step in a concentrated training program, including on the job training in HUD asset management, in-house training in various technical disciplines, self taught courses, university level classes and training sessions taught by such organizations as IREM, Institute of Real Estate Management, and Quadel.

We are also using technology to help us communicate more effectively with field staff so that they know the latest information and have the benefit of the latest policy decisions. Among the techniques we are employing to do this is an in-house bulletin board accessed through our E-mail system, allowing us to quickly put out notices of *Federal Register* publications of importance, new policy memos, and instructions to all staff. With over 80 field offices, we have found that the E-mail information has preceded the hard copy publications, significantly reducing policy information gaps. We are also using teleconferencing as a training and information dissemination tool, allowing us to reach more field staff at less cost. It also allows us to do it more frequently so that staff is continuously involved in the latest technical and policy thinking.

Field Reorganization

We are currently engaged in an extensive and important reorganization of our field staff. We are eliminating the regional offices, thereby reducing a layer of the organization and allowing field managers to report directly to me. Field offices are being given more responsibility for managing their programs and resources. They will be able to make more of the day to day management decisions directly rather than having to go through other layers of the organization. This reorganization is designed to instill top to bottom accountability for program delivery, provide more customer oriented and user friendly services, and allow us to keep pace with changes in the financial services community.

While this reorganization might not appear to be directly related to the topic before us today, I believe that increasing the flexibility and accountability of HUD managers in the field will give them the freedom and discretion they need to pursue diversions of funds. The reorganization is intended to make the most of our limited staff resources and provide those closest to the projects with the power to make the necessary decisions. This will improve our ability to catch problems early.

Second Goal—Enforcement

Enforcement in HUDprograms has been imperfect. We are aware that the view in the industry is that HUD is not going to do anything. Well, we intend to change that perception. I want to put owners and managers of our multifamily projects on notice right now that we will enforce the regulatory agreements, the regulations, and the laws.

Enforcement Task Force

We have formed an enforcement task force made up of an interdisciplinary group of HUD staff to discuss current procedures and propose new approaches to deterring diversions of funds from the multifamily inventory. In conjunction with this, we are consulting with HUD clients and industry groups who have expressed an interest in making sure HUD assisted multifamily housing is operated efficiently and honestly. As you well know, it is the few unscrupulous people who are the problems and many good, hard working owners and managers feel vilified by the inappropriate actions of the few. Many of the industry groups have made it clear that they want to weed out the bad actors to improve their own image and the industry's reputation.

Civil Money Penalties

The HUD Reform Act of 1989 permitted us to impose civil money penalties against a project owner who violates the regulatory agreement in certain specified ways. Penalties of up to $25,000 per violation can be imposed administratively after a hearing with an administrative law judge and other due process protections. While success would be never having a need to impose penalties, we are pleased with our progress, especially with our double damages remedy. To date, the government has obtained district court judgments in nine cases totalling $16,041,140, settled three cases for $2,543,152, and have three cases pending seeking damages of $5,572,926.

Property Disposition

The Congress, in passing the new property disposition legislation, has made it possible once again for us to foreclose on properties where there has been a technical default, that is, for failure to adhere to the regulatory agreement and mortgage terms. The new law permits buildings to be sold according to the purpose for which

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they were built. So unassisted market rate projects can be sold as market rate projects, returning them to productive use and the financial return can then go to the insurance fund. This has removed a burdensome and costly feature of the 1987 law, which required HUD to provide project based subsidy for every unit that was occupied by a low income family regardless of the project's market and its position in that market.

The combination of the statutory change and additional subsidy to protect low income tenants means that HUD can now make more rational and cost effective choices about removing an owner for lack of performance. We can now act more quickly.

On the surface, the new legislation does not appear to be either a deterrent to improper diversions of funds or an enforcement tool. However, it gives us flexibility to act where we could not before. Owners had irregularities in their use of funds and HUD was powerless to foreclose because we did not have the means to operate and dispose of the property. We were in the untenable position of having to leave owners in place even though we knew there were improper diversions of funds. Now, we can move against these owners and we will. Foreclosure is a long and tedious process, but most owners do not want to loose their properties, if only to avoid the tax consequences.

Operation Safe Home

This is a multiagency initiative. Secretary Cisneros has implemented it within HUD as part of an effort to improve the living conditions of the residents of HUD insured and assisted projects and public housing. We are moving on several fronts with this initiative. On the program side, we are helping owners, managers, PHAs, and tenants to rid their housing of crime. On the enforcement side, we are making sure that owners and managers of housing provide a decent, safe, and sanitary environment for the residents.

A specific focus is the effort on equity skimming. To date, we have had several successful examples of enforcement and recovery under Operation Safe Home. My colleague, Inspector General Gaffney, has described some of the recent cases where we have achieved some success.

Action Needed

Additional Improvements in Civil Money Penalties Legislation

As I discussed before, the civil money penalty provisions are currently being used as an enforcement tool. It is probably the easiest enforcement tool to apply and potentially the most effective. Because it is a civil rather than a criminal enforcement process, it can be imposed quickly using published HUD procedures. No court hearing is required before HUD decides a penalty is warranted. It also has a direct impact on the owners of the projects rather than other enforcement techniques, such as withholding rent increases or reducing subsidies which have an unfortunate impact on tenants and project viability.

However, the overall effectiveness of civil money penalties is reduced because of the limited reach of the law. Currently, the law is applicable to only some housing providers and some projects. HUD may impose penalties on owners of projects whose mortgages are insured, held, or coinsured by HUD. But there are many who are not covered, like management agents and individuals within a corporation or partnership. Further, it is not applicable to owners of Section 8 projects which are not insured under the National Housing Act. This leaves significant gaps, permitting those who may be the problem or contributed to the problem to escape financial penalty.

We would like to see the gap closed. We are considering proposing legislation to make civil money penalties applicable to non insured, federally assisted projects, to management agents, and to the principals of both the agent and owner entities. There is legislation pending in the Senate (S. 2049) which will close some of these gaps. The bill would make it clear that failure to maintain or properly manage a project is grounds for imposition of civil money penalties.

Defenses on Bankruptcy Stays

We have found that bankruptcy has limited our ability to deal with diversion of funds. In some cases, the corporate owners of projects have declared bankruptcy in order to thwart enforcement actions. We have also had owners declare bankruptcy in order to delay or even prevent foreclosure. For some owners, bankruptcy is a method of handling Federal tax consequences at the expense of the tenants and HUD.

Bankruptcy rules contain an absolute list of repayment priorities, where a secured creditor's (in this case, HUD's) position takes priority. In a bankruptcy, where the distribution of insufficient funds to pay all creditors is supervised by a court, an insider or an affiliate would typically be the last party to receive any cash. The equity skimming provisions track these priorities. An owner/manager holding, controlling and using HUD's rent collateral should only do so with HUD's permission. This would preclude a repayment of advances and the payment of other unreasonable or unnecessary expenses without HUD's permission.

The Department is pleased with the bankruptcy code amendments in S. 540 as passed by the Senate on April 21.

From HUD's multifamily perspective in particular, the addition of a definition of "single asset real estate" and the treatment of single asset debtors would be a significant enhancement to the department's position in bankruptcy cases. The overwhelming majority of bankruptcies with which HUD is confronted involve single asset real estate.

Likewise, the companion changes that would reduce the time during which the automatic stay is in effect for single asset debtors and add a flexible stay relief provision (§ 202 of S. 540) certainly are welcome.

The other major change HUD heartily endorses would be the code's recognition of a Federal standard for the perfection of security interests in revenues from single asset real estate (§ 206 of S. 540). We have been successful in arguing that recording the document that establishes the security interest was sufficient for that purpose. The code's adoption of that criterion should remove any doubts that currently linger.

Although the department has experienced a number of successes, in most cases they have been time-consuming. We have obtained favorable cash collateral orders—sometimes through negotiation, sometimes not, but the revenue that HUD-mortgaged hospitals and nursing homes generate constitute collateral that the courts have not recognized as subject to HUD's security interest on a post-petition basis. It is not clear that the amendment in § 206 would apply to HUD's interest in that type of security.

What the department would most like to see enacted are amendments (to §§ 105 and 362 of the code) that would permit HUD and the Department of Agriculture, as well as the insured lenders, to complete foreclosures of mortgages on multifamily properties. These amendments in essence would restore HUD to a position it had gained judicially under the old bankruptcy act. Ironically, the Court of Appeals decision that recognized HUD's exclusion from the automatic stay under the former bankruptcy statute was rendered just months before the current bankruptcy code was enacted. (The old law had excluded insured lenders from the stay but not HUD.)

As often as not, the reason that borrowers file bankruptcy petitions is to preserve certain tax benefits by thwarting the recapture of those benefits by the IRS. Thus, there would be a significant advantage to the government as a whole if HUD were allowed to complete multifamily mortgage foreclosures. Currently, the code allows HUD to begin a foreclosure but take no further steps without stay relief or dismissal of the case.

There is a school of thought within the bankruptcy community that single asset real estate owners are inappropriate persons to enjoy bankruptcy relief. The reasons are obvious: the one major asset owned by the debtor is encumbered beyond its value, and cash flow for whatever reason is insufficient to satisfy debt service. Why penalize the lender by depriving it of the bargained-for exchange? This question is particularly compelling for HUD projects since the loans are non-recourse.

Additional Tools

I began this testimony by saying that HUD needed your cooperation in providing us with the tools to make our efforts to eliminate the improper diversion of funds from our projects. There are some areas the executive and legislative branches should jointly consider:

- When HUD recaptures Section 8 subsidies for violations of HUD requirements, the recaptured budget authority is returned to the treasury. Subject to appropriations, this budget authority could be used to fund another project based contract or be converted to a tenant based subsidy such as vouchers. Therefore, HUD could take enforcement actions without reducing the supply of decent, safe and sanitary housing available to tenants.
- Currently, owners transferring their properties to new ownership, with new capital and renewed commitments to the extension of low income housing affordability, incur substantial tax liabilities. As a result, the owners' tax consequences become the driving force in the decisionmaking rather than best in-

terests of the residents and the taxpayers. Consideration should be given to alternative ways of addressing this problem and their cost and benefit.

- Although the property disposition legislation passed earlier this year went a long way, the Department still seeks to regain its lost authority to be exempt from bankruptcy stays when owners attempt to avoid foreclosure by hiding behind the protection of the bankruptcy courts.
- There currently exists no capital grant repair program which can be targeted at *any* assisted property with or without mortgage insurance. We have found that, in the absence of other capital funding tools, lack of such a repair program leads to further deterioration of the properties.

Conclusion

Mr. Chairman, I believe that equity skimming, diversions of funds and all the ills created by owners abusing Federal programs for improper gain should be uncovered with as much diligence as HUD's strained resources can muster. We have acted to put technology at our service and to bring our field staff up to speed on the very latest methods for keeping a vigilant eye on owners' financial practices.

However, even the best trained staff if there are too few of them cannot begin to deal with the problem. I know that it is a tired cliche to say that adequate resources equals superior performance, but in the case of HUD it is also true. The steady erosion of HUD's staffing strength and its ability to contract for equivalent services does not help solve the problem. As our programs continue to expand and grow in complexity, the strain on HUD's resources will become ever more acute. I'm afraid that unless the resource issue is not dealt with quickly and positively, you will find that this problem will outstrip our best efforts to keep it under control.

Mr. Chairman, neither you nor I, your colleagues or the Secretary want or need to see that occur. We've stemmed the tide, put systems in place. We need your help in devoting the resources to implement those systems and to reduce the tide to a trickle.

QUESTIONS SUBMITTED BY HAZEL E. EDWARDS FOR GAO

ELECTRONIC FILING FRAUD

Question 1: What is an unacceptable level of fraud, and at what point do we pull the plug?

GAO Response: In the past, the Internal Revenue Service (IRS) reported how much electronic filing fraud was being detected, but did not know how much additional fraud was going undetected. Thus, even if an acceptable level had been defined, it would have been difficult to determine whether that level had been surpassed. During the 1994 filing season, IRS conducted several fraud studies that could provide for the first time both a measure of detected fraud and an estimate of undetected fraud. We believe such studies, if properly designed and implemented, could serve as a baseline against which future progress in combating fraud could be measured. The emphasis should be on sustained progress in reducing the level of fraud. To assess its progress, we suggest that IRS repeat the fraud studies it did this year.

We hope it never becomes necessary to "pull the plug" on electronic filing. IRS needs to move away from the costly and inefficient paper-based processes that now exist, and electronic filing is currently the most practical alternative. Nonetheless, continued growth in fraud from electronically filed returns is unacceptable.

Rather than pulling the plug on electronic filing, we advocate the development of better controls to detect and prevent fraud. It is important, in our opinion, that IRS have (1) adequate procedures to identify fraudulent returns in time to prevent the fraudulent refunds from being issued and (2) processes to help it quickly react to new fraudulent schemes. There are some short-term steps that IRS could take. One step would be to improve its computerized screening criteria to more successfully identify potentially fraudulent returns. Another step would be to allow enough time to properly process the electronic return to ensure its validity before issuing the refund.

In the longer-term, IRS needs to give priority attention to using partial-year data that states receive from employers. Such data would allow IRS to verify the employer's existence and show that the taxpayer received compensation from that employer. These checks would make it harder to successfully file fraudulent electronic returns.

Question 2: Are there performance measures that GAO would suggest be included in an assessment of IRS' progress in the electronic filing program?

GAO Response: To help assess the progress of the electronic filing program, we suggest that IRS do the following.

—Determine the cost of its various efforts to control fraud and the related benefits so that responsible decisions can be made on the value of additional controls and the need to enhance or replace existing inefficient controls.

—Measure the extent of fraud and IRS' progress in controlling it by repeating the fraud studies IRS did this year. We suggest that the studies also compare the level of electronic filing fraud with that of paper return fraud.

—Measure the number and percent of total returns that are filed electronically to assess progress in reaching the goal of 80 million electronic returns. To help identify areas where IRS needs to focus its marketing efforts, this measure could be broken down by such categories as (1) type of return (1040s, 941s, 1041s, etc.), (2) geographic location, (3) type of taxpayer (wage earner, sole proprietor, corporation, etc.), and/or (4) wage level of taxpayer.

—Measure the savings being achieved through electronic filing by category. An increase in electronically filed corporate returns, for example, could generate more savings than an increase in electronic returns filed by wage earners because corporate returns are longer and more complicated than wage earners' returns and thus could involve higher labor and storage costs when filed on paper.

—Measure the accuracy of electronically filed returns compared to paper returns. Maintaining a high accuracy rate is important to achieving some of the major benefits of electronic filing, such as less rework to correct errors and increased taxpayer satisfaction.

—Measure the percent of preparers participating in the electronic filing program, broken down by size of preparer (preparers who prepare fewer than 10 returns, preparers who prepare between 10 and 100 returns, etc.). Because about one-half of all returns are prepared by someone other than the taxpayer, the preparer community is pivotal to the success of electronic filing.

—Measure customer satisfaction through periodic surveys that gauge taxpayer and preparer satisfaction with various aspects of the electronic filing program.

Another measure that should be used, but only in conjunction with other measures, is the speed with which refunds are issued. We believe that using speed as the primary, or as an isolated measure, has contributed to the problem IRS now faces with fraud. IRS needs to find some way to sustain timely processing of refunds while strengthening controls over processing electronic returns to ensure that only valid refunds are paid. Otherwise, the goal of 80 million electronically filed returns by the year 2001, which is critical to achievement of IRS' future business vision, will be unattainable.

COMPUTER SECURITY

Question: To the extent that you can discuss it publicly, what concerns do you have about IRS systems security, and why have some of the issues gone uncorrected for a number of years?

GAO Response: We and IRS' Internal Audit Division have brought a number of specific security weaknesses to IRS' attention. Our overriding concern is that taxpayer data is not properly protected from unauthorized access.

Of special concern is the absence of a comprehensive risk analysis to identify the security vulnerabilities in IRS' systems, considering the entire environment in which the various systems are used and accessed. IRS has analyzed parts of its environment, but has neglected others. A comprehensive risk analysis of all systems is necessary to ensure that major security weaknesses are not overlooked as the necessary technical safeguards are designed and implemented.

Although IRS has been studying specific aspects of systems security for several years, many weaknesses have not been corrected. In particular, senior management had not previously devoted the necessary attention to systems security and failed to maintain the emphasis necessary to fully protect sensitive data in an electronic environment. For example, the Commissioner's Task Force on Privacy, Security, and Disclosure found that (1) IRS had placed emphasis on maintaining production levels as the primary objective, (2) local managers frequently diverted resources from security to operational needs, and (3) adequate cost/benefit analyses were not always done to determine the cost of privacy and security versus their impact on operational decisions.

Our observation has been that IRS emphasizes the security of its physical premises and paper-based taxpayer data. However, our review results indicate that IRS has not been as diligent in the protection of sensitive taxpayer data in electronic form.

BROWSING/UNAUTHORIZED ACCESS

Question 1: What steps must IRS take to make sure that the Electronic Audit Research Log (EARL) is used effectively?

GAO Response: EARL is an important tool for identifying potentially unusual activities in the use of the Integrated Data Retrieval System within a given work group, but work group managers must analyze, review, and investigate each instance reported by EARL to determine whether unauthorized disclosure of taxpayer data has occurred. Since managers' time is at a premium, the reports that EARL generates must be easy to use and contain the type of information that will facilitate managers' identification and investigation of unusual circumstances.

To meet these objectives, IRS should ensure that the EARL reports are concise and easy to read. The reports should also highlight the particular factors that caused the activity to be reported. In addition to making the EARL reports user-friendly, IRS should tailor EARL's analysis of system activity as much as possible to individual work groups. This step is important to reducing the number of potential breeches that managers must investigate because the frequency and pattern of normal access to taxpayers' accounts vary widely among different work groups.

Question 2: What role will management have in detecting and addressing abuses, and have they been adequately trained for this?

GAO Response: According to IRS, managers will be responsible for analyzing, reviewing, and investigating each occurrence of potentially unusual activity reported by EARL to determine if an unauthorized disclosure of taxpayer data has occurred. In addition, managers will be able to query EARL on an ad hoc basis to test for types of unusual activity not covered by EARL's predefined reports.

At the time of our review, specific training courses for managers had not been designed or developed. We believe it is important that managers are trained to (1) recognize the types of activity that lead to unauthorized disclosure of taxpayer data and (2) effectively use EARL as a tool for detecting unusual activity.

RESPONSES TO QUESTIONS FROM MARGARET RICHARDSON

QUESTIONS FROM CHAIRMAN GLENN

Question 1: I don't think Congress can watch fraud double each year in the electronic filing program without considering some sort of suspension or moratorium until things are under control.

What is an unacceptable level of fraud in electronic filing, and at what point should we consider suspending the program?

Are there some better safeguards and program performance measures you'd be willing to live with? Are you willing to provide them to the Congress before the next filing season?

Answer: The Service does not view any level of fraud as acceptable and would be reluctant to set any goal that created the perception of a tolerance for fraud. We are concerned with the growth of detected fraud in both the electronic and paper filing systems but also believe that a large portion of the growth in detected fraudulent claims is due to our increased fraud detection efforts rather than a specific vulnerability of the electronic filing system. In fact, the electronic filing system offers the potential for enhanced fraud detection as compared to the paper system because of the availability of 100% of the information on the return and the ability to track the source of the return to a specific preparer/transmitter.

We are implementing many new systemic and procedural changes to improve fraud detection capabilities for the next filing season. These changes are being incorporated on both the electronic and paper filing systems. Generally, these improvements involve greater scrutiny and validation of social security numbers on tax returns, improved scoring formulas and matches for identifying suspicious claims, enhanced automation support for tax examiners (the Electronic Fraud Detection System), improved suitability and monitoring reguirements for electronic return preparers / transmitters and additional resources committed to identifying and resolving suspicious claims. To provide further detail in a public forum could compromise the value of our specific plans. However, we would be able to provide greater specificity in private briefings for the committee members or the committee staff.

It is also important to recognize that fraudsters continue to change their methods of filing false claims. As improved protections are designed and implemented, the fraudster is designing new ways to circumvent these controls. It is a constant and evolving environment. This also means that estimates of levels of fraud in one year may not be accurate or predictive of the level of fraud in subseguent years.

Question 2: Your testimony mentions several measures that IRS has taken recently in an effort to combat electronic filing fraud.

Do you know yet whether or not those measures have helped?

To the extent that you can tell us without compromising fraud detection efforts, what plans are underway for detecting fraud in the 1995 filing season?

Answer: We believe that our efforts to combat fraudulent claims in the 1994 filing season were very helpful. We know that we detected more claims, prevented refunds from being issued and initiated more criminal investigations. Our systemic comparisons of information caused many suspicious returns to be rejected outright frpm the electronic filing system. Our studies of Earned Income Tax Credit (EITC) compliance substantially increased our understanding of fraud and abuse in this area, which resulted in better identification of returns for examination during our filing season EITC initiative. And the studies' results are also being used to substantially sharpen the formulas used to detect fraudulent claims. Our analysis of SSN problems provided data to support the need for increased checks in the 1995 season.

We have provided a summary of the 1995 plans in the previous answer.

Question 3: What is your explanation for why the amount of fraudulent returns detected by the IRS is growing so rapidly? Are more Americans attempting to cheat the system and the IRS simply never knew it before?

Answer: As noted in our previous answers, we believe that a large portion of the increase in detected false claims is due to our increased efforts during the past several years. The combination of increased resources and increased detection efforts has led to increased detection. However, we cannot make any precise or supportable statement about the portion of detected fraud that is due to increased detection or the portion that is due to increased non-compliance by taxpayers.

Question 4: Your testimony points out that fraud detection for electronic returns is hampered because detection is a manual process which is slow and labor intensive. As a result, refunds are issued before some returns are reviewed for fraud.

IRS has made changes to automate some fraud detection but, as I understand this process, it still requires manual reviews. Will IRS be able to review all returns before sending out the refund checks?

Would more resources help in this area? Could you detect more fraud if IRS had additional resources?

Answer: The long term goal for a state-of-the-art fraud detection system embodies the concept that all returns will be screened prior to refund issuance. This process would be highly automated using sophisticated data comparisons, anomaly detection algorithms, statistically based scoring and other machine based techniques. Of those returns identified as suspicious, our employees would still review the return to insure that legitimate taxpayers with legitimate but unusual claims receive their refunds. But even this phase of manual review would be substantially supported by enhanced automation for data query and confirmation by the tax examiner performing the review. These capabilities offer the potential for :Lhe IRS to review all suspicious returns before issuing refund checks.

In the short term, we are developing this capability with the Electronic Filing Detection System and the research on anomaly detection being performed by Los Alamos National Laboratory. But the potential to realize the long term goals is dependent on the availability of data and computing power to be provided by the Tax Systems Modernization (TSM) design.

With regard to additional resources, the simple answer is yes. Additional resources would allow more suspicious returns to be reviewed before refunds were issued. Additional resources are being devoted to filing fraud out of the FY 1995 compliance initiative. We are working with Treasury and OMB on additional needs for FY 1996.

Question 5: GAO has stated its concerns about overall systems security which it included, in a confidential report to this committee and to IRS. Are GAO's concerns warranted? Why have some of the issues gone uncorrected for a number of years?

Answer: The material included in GAO's testimony was predicated on their draft report. The Service has met with GAO subsequent to the hearing with respect to the tone, and context of the report, as well as, the accuracy of certain conclusions included in the draft. GAO committed to review our concerns and determine how they might affect the draft report provided to the Committee.

In any case, we still believe that there are certainly areas for improvement. However, we believe we have been, and are continuing to take significant and positive actions in this regard. We have shared with the Committee both the specific efforts the Service has initiated, as well as status reports on the progress of these efforts. Those actions with respect to the Integrated Data Retrieval System (IDRS) are summarized in the attachedIDRS Privacy and Security Action Plan Report for July. We believe that all of the training, leadership and corrective actions have been, or are

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being, addressed, and we continue to be available to meet with your staff to review in more detail our accomplishments.

Question 6: I am disturbed that more than 500 IRS employees have been investigated for unauthorized access to taxpayer files since around the time of our hearing a year ago. While many of those people were cleared of wrong-doing, and not all of these cases are browsing, we are still talking about a number of willful violations of Americans' privacy by the government.

You've issued a stern warning that IRS won't tolerate browsing. Are employees ignoring it?

Answer: To the contrary, the vast majority of employees who have access to IDRS data do not exceed their access authority. Our employees accessed IDRS data over 1.2 billion times last year; but only a handful were found to have exceeded their authority. Abuses of taxpayer rights of privacy will simply not be tolerated, and we have taken a number of actions to curb and prevent the kinds of violations publicized as a result of this Committee' s hearings.

In January 1993, we established the Office of the Privacy Advocate, which now serves as a focal point for all taxpayer-privacy concerns at the IRS. I have appointed a recognized privacy expert to serve as the agency's first Privacy Advocate. This office and position are unique in the federal government in that their sole focus is on privacy.

I recently issued a set of privacy principles which will form the foundation for the stronger privacy protection program we are building in the Service. All IRS employees will be expected to exhibit individual performance which adheres strictly to those principles.

We also have a new training program which clearly lays out the responsibilities of IRS employees for taxpayer privacy protection. It deals squarely with the issue of browsing taxpayer records, and every IRS employee will receive this training by the end of the year. I should note here that the IRS has a tradition of protecting taxpayer privacy which is a part of our culture, although it is clear that we need to demonstrate to our employees, the Congress, and most importantly, to our taxpayers, that our tradition has not been abandoned.

Some computer systems in use within IRS date back to the 1960's and the computer security controls on these systems do not detect unauthorized accesses to taxpayer data as quickly as we would like. Tax Systems Modernization will allow much quicker detection and enhance our ability to prevent unauthorized accesses in the future.

In your opinion, should Congress take stronger action; should we, perhaps, institute some criminal sanctions against browsing?

Answer: There are already criminal penalties in place to deal with the more egregious forms of browsing. Based on a comprehensive review of all the penalties imposed, we have now implemented a standard set of penalties which will ensure that our managers fully understand all the disciplinary options available to them, that greater consistency in discipline is achieved, and that discipline imposed reflects the gravity of the offense.

The message on unauthorized access may take some time to sink in. When do you expect to have this problem under control? Will we have to have another hearing on this next year?

Answer: The message has sunk in, given the small numbers of employees who we found had exceeded their access authorization. I think that the implementation of the technical and managerial controls I mentioned above will even more significantly reduce the problem. In any case, I would be happy to appear before this Committee next year and talk about our progress in this effort.

Question 7: At our hearing a year ago, Senator Pryor asked whether IRS would notify taxpayers when employees had browsed or inappropriately accessed their files. Have you made a decision or taken action?

Answer: The concept of notification is not an isolated issue. Rather, it is part and parcel of a larger, more complex subject. Specifically, I am referring to the privacy rights of all taxpayers. We have not done all that we can to protect those rights. I am committed to dealing with that problem in its entirety, rather than dealing separately with the single issue of notification.

On October 15, 1993, I signed and issued the IRS policy statement on Taxpayer Privacy rights. In May 1994, I signed and issued the Service's ten Privacy Principles. These Rights and Principles provide the framework for all IRS policies relative to taxpayer privacy.

I am taking action on several fronts to enhance taxpayers' privacy. I have appointed and brought into the Service a recognized expert to serve as the IRS Privacy Advocate. We are informing and educating all managers and employees of their responsibilities and duties in the privacy/security areas. I have placed great emphasis

on PREVENTION of violations of taxpayers' privacy rights. I have also moved to implement a specialized computer approach (the Electronic Audit Research Log) to detect violations when prevention fails. In the long run, Tax Systems Modernization will enable the Service to prevent violations in most instances. Furthermore, penalty guidelines for disciplinary actions for violation of taxpayer privacy have been stiffened and widely publicized.

Further, I have appointed a Privacy and Security Implementation Task Force to assure that the Service deals with all open issues in the subject area. That group will recommend to me a notification policy within the broad privacy/security context in the September/October timeframe. I will be making a decision on the notification issue before the end of the calendar year.

QUESTIONS FROM SENATOR COCHRAN

Question 1: It appears the benefits associated with the Information Highway may be offset by increased fraudulent filing. If the estimates of as much as $9 billion are close to accurate, and your success rate against electronic fraud is 67% compared with 95% against paper fraud, is it worthwhile to continue to permit electronic filing?

Answer: I believe it would be short-sighted for the IRS to abandon its electronic filing system because of increased detection of fraudulent filing. We have witnessed increased fraud detection on both our electronic and paper filing systems, so the problem does not appear to be an issue of the medium. The American economy is clearly headed for an age of electronic commerce and for the Service to remain a paper processing factory would result in increased costs, inefficiencies, reduced taxpayer satisfaction and reduced fraud detection capability. Clearly the challenge is to realize the benefits of electronic commerce (and electronic filing) while improving fraud protections. The electronic filing system offers greater potential for fraud detection because 100% of the tax return is available for screening and comparisons and because we know the source of the return.

Although the IRS does not subscribe to the $9 billion fraud figure, it apparently refers to estimates of losses to EITC fraud and abuse on both electronic and paper returns, not fraud losses to electronically filed returns.

Lastly, this question recategorizes our refund deletion rates for paper and electronic filing as "success rates". I would like to describe how these rates are computed and the risk of viewing them as success rates. After a claim for refund is identified as suspicious, we attempt to confirm information on the return. When these confirmations indicate the claim is false or falsely inflated, we "freeze" the claimed refund from being released. We compute the refund deletion rate by dividing the total refund dollars stopped or "frozen" by the total refund dollars claimed on confirmed suspect returns. There is a reason why the deletion rate for electronically filed returns is lower than paper returns. That is after a suspect return is confirmed we can detect similar returns more easily on the electronic system. The availability of 100% of return data and the ability to track returns to their source, allows us to more accurately and thoroughly search through previously filed returns to develop multi-return schemes. The downside to this capability is that the refunds on returns not previously detected are usually gone and the deletion rate is reduced. Yet, the goal of identifying other returns in the scheme is the desired objective even if deletion rates are negatively impacted.

RESPONSES TO QUESTIONS FROM JAMES THOMAS, U.S. DEPARTMENT OF EDUCATION

GATEKEEPING

1. According to your testimony, the Department of Education did not do an adequate job of screening the schools that were allowed to participate in the old, guaranteed student loan program and, as a result, the program often fell victim to financially weak and unscrupulous schools. You also state your concern that this "gatekeeping" problem could plague the new direct loan program.

—Has the Department significantly improved its screening procedures? Are we using these improved procedures to screen schools for both the guaranteed loan and direct loan programs?

—As I understand it, a school with a default rate in excess of 25% is currently prohibited from participating in the student loan program. Is the Department planning to abandon use of cohort default rate as a measure of performance?

Answer: To provide some background, during 1989 through 1991 we issued four audit reports on each of the "gatekeeping" processes; accreditation, eligibility, finan-

cial and administrative certification. Based on the deficiencies identified, collectively we concluded that gatekeeping was ineffective in preventing substandard schools from beginning participation in the Student Financial Assistance (SFA) programs.

During the summer of 1993, we performed limited follow-up reviews of the gatekeeping processes to determine the progress of the Department in implementing corrective actions. Our conclusion was that although the Department had made significant strides to improve gatekeeping, all corrective actions were not consistently implemented.

The Higher Education Act amendments of 1992 provided many new provisions to strengthen gatekeeping. The regulations implementing these new provisions became effective July 1, 1994, therefore, the Department now has the opportunity to further improve gatekeeping by effectively implementing these provisions.

By statute there are stricter and specific selection criteria (gatekeeping) for participation in the first year of the new Direct Loan program. Among the criteria were prior participation by the school in other SFA programs and a history of compliance with program requirements. Therefore, no new schools are in the Direct Loan program, while new schools continue to begin participation in the Federal Family Education Loan Program (FFELP) under the gatekeeping processes for all the other SFA programs. In future years the selection criteria for schools to begin participation in the Direct Loan program are not specified in the statute. With the statutorily mandated expansion of the Direct Loan program the less restrictive gatekeeping processes used for the other SFA programs could eventually be used for the Direct Loan program.

Regarding your question on default rates, I am not aware of any plans by the Department to abandon the use of default rates as a measure of performance. Also, under current regulations a school with a cohort default rate above 40% in one fiscal year may be subject to termination from all the SFA programs through the Department's administrative hearing process. A school with a cohort default rate of 25% for three consecutive fiscal years loses its eligibility for participation in the FFELP, subject to appeal by the school.

DATA ACCURACY

2. You have reported that Education's relationship with schools, guaranty agencies and lenders did not work to its benefit and, as a result, the Department doesn't have complete and accurate information on individual borrowers and their loans. The Department is, therefore, unable to determine whether it is receiving or disbursing the correct amounts for the guaranteed loan program.

—What do you think Education's chances are for getting complete and accurate information for its National Student Loan Data System now that guaranty agencies and lenders are leaving the guaranteed loan program?

—For the direct loan program, do you think that Education is dealing with the participating schools from a position of strength and that the Department will be able to control the quality of data it receives from the schools?

Answer: As the volume of loans in the FFELP is significantly reduced over the next several years, as you have stated, guaranty agencies and lenders will be leaving the program. Therefore, the incentives for all FFELP participants to take the necessary actions to provide complete and accurate data into the National Student Loan Data System (NSLDS), are limited. However, since the NSLDS will be an on-line data base obtaining information on a monthly basis from the guaranty agencies, the Department's ability to obtain more timely data will be significantly enhanced. This in turn, will enable the Department to more timely identify data problems and take action.

Since we have not been directly involved in the Department's dealings with the initial 104 schools participating in the Direct Loan program, at this time we cannot comment on whether or not the Department is dealing from a position of strength. Under the simplified structure of the Direct Loan program the Department is the only lender and there are no guaranty agencies as intermediaries, therefore, the Department should have the capability to control the quality of the data received from the schools.

QUESTION FROM SENATOR LIEBERMAN

1. Mr. Thomas, from your perspective, how serious are the 11 deficiencies in the Title IV delivery system the Advisory Committee identified? Importantly, will the direct loan program be subject to fraud and abuse given the inability of the Department to track borrowers limits and student eligibility under the current system conditions?

Answer: We believe that the deficiencies identified by the Advisory Committee in the Title IV delivery system are very serious. Many aspects of those deficiencies have been reported on by the Office of Inspector General over the years. We believe the Department is committed to improving the delivery systems, but that is a very complex task.

Since a new more efficient delivery system was designed and developed for the Direct Loan program, together with the implementation of the National Student Loan Data System later this year, the Department should have the ability to both track student eligibility and loan limits. Even with these improvements for the Direct Loan program, no program can be completely safeguarded from fraud and abuse.

QUESTION FROM SENATOR COCHRAN

1. Have adequate time and resources been made available to DoED for the development of the direct lending program, specifically training for the DoED staff, assistance and training of participating colleges and universities, and the management information systems?

Answer: I did testify before the Permanent Subcommittee on Investigations on October 28, 1993, that the Department did not have sufficient resources. However, subsequent to that hearing the Department has undertaken hiring staff to administer the Direct Loan program. We have not performed any analysis of the adequacy of these resources.

As stated in my testimony, in accordance with the timeframe established by statute on August 10, 1993, the Department was required to develop and implement the system for the Direct Loan program to begin on July 1, 1994. The new system had to be operational by June 15, 1994, which is a very short timeframe for development of a new system. Because of the short timeframe, even though the Department met the statutory requirements, some testing could not be performed until the system was operational and many changes to the system had to be deferred to the second year of the program.

RESPONSES TO QUESTIONS FROM SUSAN GAFFNEY, U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

EQUITY SKIMMING

Question 1(a): Could you explain your statement that at times tools available to HUD for discouraging equity skimming actually work as a disincentive?

Response: The following circumstances have effectively served as a disincentive for HUD to aggressively pursue the use of available program enforcement tools to deter and sanction equity skimming:

1. In cases where HUD declares a default of an insured mortgage for regulatory violations, this results in the payment of a costly claim from the FHA insurance fund. In addition, if HUD pursues foreclosure on the property, a lengthy and expensive disposition process can follow if the owner files for protection under the bankruptcy laws.

2. In cases where HUD declares a default of a Section 8 housing subsidy contract and abates the rental subsidy or terminates the contract, the subsidized tenants are left without affordable housing because HUD has no authority to reprogram the remaining subsidy contract funding to provide alternative housing. An equally undesirable alternative is that residents will continue to live in unacceptable housing and HUD will pay a claim from the insurance fund because the owner will likely not pay the mortgage or repair the units without subsidy funding.

3. In the case of other tools employed by HUD, such as denying rent increases or other forms of financial relief, they ultimately tend to hurt low income tenants more than they do project owners, whose personal financial status generally remains unchanged.

All of these concerns, coupled with the lengthy and staff intensive processes involved in taking enforcement actions, have contributed to a HUD culture which often disregards the use of available enforcement tools.

Question 1(b): Are there steps that we in Congress can take to make these tools work better—or is it up to management? Is new legislation needed?

Response: Action by both HUD management and Congress is needed for an effective enforcement strategy against equity skimming. On the management side, HUD has three systemic weaknesses that adversely impact its ability to effectively deliver all its programs. In general, HUD has insufficient human resources, its data systems are outdated and unreliable, and its management control environment needs

major improvements. These weaknesses significantly impact multifamily housing operations, and specifically enforcement activities. Without necessary project performance data and adequate staff resources, HUD's ability to detect problems and take appropriate corrective actions is inadequate and limited-at best.

As for needed Congressional action, improved enforcement legislation proposed by HUD and currently pending Congressional Conference, includes provisions to improve the equity skimming statutes, expand civil money penalty provisions, and allow recapture of Section 8 subsidy funds that are now lost if enforcement actions are imposed on owners. We fully support these legislative proposals and urge Congress to pass these measures.

Although we also support current attempts being made by HUD to modify the Bankruptcy Code for reducing the time a debtor has to submit a workout plan, we believe changes to the Code need to go further. HUD's program enforcement would be more effective if the Bankruptcy Code were changed to permit a total exemption from the automatic stay provisions of the Code. By filing for protection under the Bankruptcy Code, owners prevent HUD from foreclosing and taking possession of the property quickly and better protecting the interests of the tenants and HUD. With an exemption from the automatic stay provisions, HUD would be able to foreclose with only minimal delay.

Our office has initiated other legislative changes for increasing the "criminal" penalties for equity skimming, holding owners personally liable for losses incurred by the Federal Government due to equity skimming, and making the penalties for obstructing a Federal audit applicable to HUD's multifamily insurance programs. Congressional action is needed for these changes.

In addition, we believe that Congress should consider other changes to the basic structure of HUD's multifamily programs to significantly change an owners' incentive to engage in equity skimming. The design of HUD's multifamily mortgage insurance programs often requires only a minimal equity investment (10%) and that investment usually consists of noncash items such as fees and profit allowances earned during construction of the project. In the case of programs for refinancing existing projects, owners are allowed to withdraw their invested equity as part of the new mortgage proceeds.

So, with little vested interest, owners often have more to gain by diverting project funds than they would by using the funds for continued project operations. We need to design the multifamily housing programs so that owners cannot afford to misuse project funds because they will be jeopardizing their own, more substantial, investment in the project. An increase in the equity requirements of owners reduces the risk to the Federal Government and the tenants. This more naturally places the burden on the owner to properly operate the project, and reduces the burden upon HUD to catch the violator.

When considering changes to the design of the HUD's multifamily housing, care must be given not to provide owners with financial incentives for causing a project to be troubled. For example, allowing owners of troubled projects to sell their interests to other owners preferred by HUD, and providing the owners relief from exit tax liabilities resulting from the sale, may serve as an incentive to an owner to cause or allow a project to deteriorate. This type of change in the program may give the wrong message or provide a disincentive for properly maintaining properties.

We further propose changes to the equity skimming and double damage statutes to expand their applicability to HUD's new Risksharing Program. This program is expected to provide the majority of multifamily rental housing development sponsored by HUD for the foreseeable future. Currently, the equity skimming and double damages statute only applies to HUD's full insurance and coinsurance programs. Although the Risk-Sharing Program is designed to be administered by institutions who do not have the authority to pursue the remedies provided by the equity skimming and double damage statutes, HUD is still financially and programmatically at risk, and remedies to deter equity skimming are still needed in this new development program.

Question 2: What impact do poor systems have on the multifamily housing program and on combatting equity skimming?

Response: HUD's multifamily systems do not provide necessary and reliable information for effective program management and project oversight. The lack of modern systems makes staff usage less efficient and monitoring loans less productive. Adequate systems support would greatly aid HUD staff in identifying troubled multifamily projects where equity skimming is most often found, and where it has the most devastating effects upon the tenants and HUD funding. Automation of critical information from annual project financial statements and physical inspections would better enable HUD to timely pinpoint equity skimming and other problems, and focus enforcement or other appropriate corrective actions.

Question 3: What are the difficulties involved in the recovery of funds from owners who engage in equity skimming and would additional legislation help?

Response: The inability to recover misused funds from project owners is primarily due to HUD's lack of leverage. As discussed in the response to Question 1 above, there are disincentives against HUD's pursuit of program enforcement actions. Owners know that HUD does not aggressively enforce its program requirements because most available enforcement actions have the potential to hurt HUD or HUD's intended beneficiaries, the tenants, more than the owners. So, HUD most often is left with making requests for compliance with no real threat of actually being able to force the issue. Legislation is needed to allow HUD to pursue recovery while at the same time minimizing the impact on the tenants and the Treasury. As discussed earlier, some legislation has already been proposed or initiated, while still other changes to the design of the FHA programs need to be considered by Congress.

Question 4: Should OIG be conducting more audits of multifamily housing projects?

Response: With Operation Safe Home, we have increased our efforts to pursue equity skimming violations. We have tailored our audits to focus on equity skimming and have doubled the number of such reviews that will be conducted this year as a result, while at the same time reducing the staff days required to do so. However, more audits and program monitoring to detect equity skimming is not the total answer to controlling this problem. We also need to change what happens as a result of these audits and reviews. Successful prosecutions and settlements must result to demonstrate to project owners that HUD has the will and the ability to enforce compliance with its program requirements. We must create a strong deterrent effect within the industry.

Question 5: Could you explain the impact equity skimming has on the families living in these properties?

Response: Equity skimming deprives projects of needed funds for repairs and maintenance. This in turn contributes to the financial and physical deterioration of projects, and resultant substandard living conditions for the millions of families who depend upon the Federal Government to provide housing. The communities where these projects are located also suffer because they become the breeding ground for crime, violence, and drugs.

During our audits of multifamily housing projects, we often find apartment units containing serious tenant health and safety hazards, including roach infestation, falling ceilings and windows, and doors that did not provide security or protection from the weather. Many of the families at these project did not have the luxury of being able to move to another apartment of their choice because they relied on the HUD unit based subsidies to help make their rent payments. Protecting these tenants must be our first priority.

Question 6: What else needs to be done beyond better enforcement and legislation to control equity skimming?

Response: The cure to the problem of equity skimming is not simple. A concerted effort is needed on several fronts to bring this problem under control. As already mentioned, changes are needed in program design, enforcement legislation, human resources, and data systems. However, the effectiveness of all these changes is predicated upon a new HUD "attitude" that it is no longer business as usual. This "attitude", must be driven by the principle that tenants rights to safe and sanitary housing will be protected at all costs. In addition, HUD must insist that it gets a fair value for its housing subsidy dollars. In many cases, HUD's lack of effective program enforcement has allowed projects to deteriorate to the point where HUD cannot avoid a costly solution. For projects in good standing or on the margin, a strong program performance and enforcement culture is needed to avoid future losses. This must be HUD's top priority for its multifamily housing programs.

QUESTION FROM SENATOR COCHRAN

What are your initial impressions regarding HUD's protection against fraud, waste, and abuse? Are there particular programs that you will focus on during the next 2 years?

Having served as HUD's new Inspector General for the past year, it is my opinion that HUD's program risks are inherently high, and its control environment generally poor. The OIG has appropriately focused attention on the "top 10" problems facing HUD management. These problems include:

—Systemic Weaknesses
—Management Environment
—Resource Management
—Data Systems

—Programmatic Weaknesses
—Multifamily Asset Management
—Single Family Asset Management
—Community Planning & Development Program Delivery
—Public Housing Management
—GNMA Contract Administration
—Section 8 Budgeting and Accounting
—New Program Implementation

We have reported on the nature and status of those problems in our Semiannual Reports to Congress for the periods ending March 1992, March 1993, September 1993, and March 1994. It is my intention to continue to focus OIG resources on being a force for positive change in these top 10 problem areas, and to apprise the Congress of progress made in our Semiannual Reports over the next several years.

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